Short Term Capital Loss

For the last fiscal year (ended March 31, 2008), I incurred a short-term capital loss on the sale of mutual funds. I will not be able to use the current year's entire short-term loss to offset the capital gains as the short-term losses are higher than the gains. Can I carry forward these short-term losses to offset the capital gains in the future years?

Yes. According to Section 74 of the Income Tax Act, 1961, you can offset your losses and even carry forward them for eight assessment years immediately succeeding the year in which the loss was first computed.

As per the act, any loss related to a short-term capital asset (like the sale of equity funds/shares within one year), can be set off against income under capital gains in respect of any other capital asset (be it short-term or long-term). This means, you can even offset this loss against any long-term capital gain. For instance, let's say you invested in a debt fund. After a year, you sell the units and book a profit (long term capital gains). You can offset this gain with your short-term mutual fund investment loss.

Long-term Loss Vs Short-term Gain

Can I offset long-term capital loss against short-term capital gain?

There has been a major shift in policy on setting off and carry forwarding the unabsorbed loss since April 1, 2002. Setting off loss from one source of income against another is allowed except in the case of capital gains. This is the law as it stands now:

1. Loss falling under heads of income other than 'Capital Gains' can be set off against income from any other source under the same head.

2. Short-term capital loss can be set off against any income under the head 'Capital Gains' i.e both short-term as well as long-term.

3. Long-term capital loss can be set off only against long-term capital gains.

Before this amendment long-term losses could be adjusted against short-tem capital gains thereby allowing a substantial tax saving.

Unabsorbed long-term loss can be carried forward for up to eight years and be used to set off unabsorbed loss in any of those years. Notably, long-term capital gains that arose before the amendment in the law last year are also affected by the change—in the future, even old losses cannot be used to set off short-term gains.

The situation for short-term losses remains unchanged. These can be used to set off both long-term and short-term profits made in the same year. And as earlier, they cannot be carried forward.

Long-Term Capital Gains

I purchased units of a Mutual Fund in 1998. On 24/03/1999, bonus issue was announced and for each unit held; I was allotted one bonus unit. Recently, I redeemed all the units and want to compute long-term capital gain tax on both original units as well as bonus units. I understand that there are two options, which I can use. One of the options is to calculate tax at the flat rate of 20% after taking indexation benefit. The other option is to calculate tax at the rate of 10% without taking advantage of indexation. Can I opt for fist option for original units and second option in case of bonus units?

Usually long-term capital gain is taxed at a flat 20% on gain arrived at after adjusting cost of acquisition and improvement with cost inflation index. However, a preferential tax treatment exists in case of long term gain arising on sale or transfer of listed securities or units of mutual funds. Firstly gain is calculated without applying cost inflation index and by calculating tax at a flat rate of 10 per cent.

In the second step, gain is calculated after applying cost inflation index, as usual, calculating tax at a flat rate of 20 per cent. The lower of the two alternatives is your tax liability. Thus the investor is neither free to choose, as suggested by you, from either of the two options, nor can he opt for different methods for listed securities. In-fact this provision is quite investor

friendly and will help you minimise your tax liability.

Capital Gains and STT

Do I have to include the Securities Transaction Tax (STT) when calculating capital gains tax?

The generally accepted methodology is to take the full value of the transfer, deduct the cost of acquisition and calculate the applicable tax rate on this amount. So don't make the mistake of adding back the STT that has been deducted.

Let's say you invested Rs 80,000 in an equity mutual fund. At the time of redemption, the amount is Rs 1,00,250. But out of this amount, you only get Rs 1,00,000 as Rs 250 is deducted on account of STT.

The capital gain will be calculated on the sales proceeds received, which is Rs 1,00,000 in your case. Therefore, short-term capital gains will be Rs 20,000 and you will have to pay a short-term capital gains tax at the rate of 10 per cent (plus cess and surcharge) on this amount.

Tax Implications on investments made in ELSS funds

I had invested Rs 1 lakh in 2006 in the HDFC Tax Saver ELSS. What's the tax implication (long term capital gains tax/income tax) when I redeem units in 2009. Will the profit/principal or both be included in the income for year 2009?

HDFC Tax Saver is an equity linked saving scheme (tax saving mutual fund). As it is an equity oriented fund (those with equity exposure greater than 65 per cent), there would be no tax liability on the redemption amount. The income in the form of dividends (if any) from an equity fund are also tax free in the hands of the investor.

Tax Implications on Scheme Transfers

After staying invested in a particular mutual fund for more than a year under the dividend payout option, I switched over to the growth option. I remained invested in the growth option for a period of two months and then redeemed my investment. What are the tax implications?

The dividend and the growth option constitute two different schemes of a mutual fund with two different NAVs. If you opted for a shift from dividend

option to a growth option, it is actually an inter scheme transfer which is considered as a fresh investment in the growth scheme on basis of the transfer date's NAV. This transaction is similar to redeeming the investment manually from the dividend option and then investing the same in the growth option of a fund. There is no associated tax liability if an equity fund is held for more than a year. As you were invested in the dividend option of the fund for a period exceeding one year, there is no tax on the redemption amount which is transferred to the growth scheme (STT is deducted by the fund before paying you the amount). After the transfer, as you redeemed your investment after two months, you would need to pay a short term capital gains tax of 15 per cent on gains. This is to be disclosed when your file your income tax return at the end of the fiscal.

Offsetting Profits Against Losses

I earned Rs 25,000 by trading in stocks this year. I also booked losses of Rs 5,500. Can I offset these losses against my gains and reduce my tax liability?

According to Section 74 of the Income Tax Act, you are allowed to offset your losses and even carry forward them for eight assessment years immediately succeeding the assessment year for which the loss was first computed. If a loss relates to a short-term capital asset, it shall be set off against income under Capital gains in respect of any other capital asset. If loss relates to a long-term capital asset, it shall be set off against income, if any, under the head Capital gains assessable for that assessment year in respect of any other capital asset not being a short-term capital asset. You need to note the difference in treatment of loss on a short and long term capital asset. As in your case it is a short term capital loss, you can offset it against the income under capital gains (Rs 25000). So you can pay taxes on Rs 19500.

Now that you are done with your tax planning for this year, it would be ideal to start early for the next fiscal. You might have managed to get lower NAVs because of the recent market crash this time but as we stress you should never try to time the markets. Start investing in tax saving mutual funds via the SIP route. Just compute your annual salary and calculate how much you wish to invest in tax saving mutual funds. Just equally divide the amount in 12 instalments and get started.

There is also a reason to cheer as the tax slabs for the coming financial year have been revised significantly. So here is a ready reckoner for you to calculate your tax liability for next year and get started at the earliest. We are also recommending a few funds where you can start investing via SIP from early April.

Investing, Trading and Speculating

I am a part-time investor, investing in shares and units of mutual funds on long-term basis. I also do trading of shares including some intra-day trading, where I square off my transactions without taking delivery. Can I adjust my trading losses against gains arising from investment?

In my view, you are doing three activities — investing, trading and speculating. An investment activity is where you invest with a longer time horizon in mind. The intention is to enjoy appreciation over a period of time, to earn dividend, and to enjoy bonus and rights. Depending upon the period of holding, gains arising on sale of such investments are treated as long-term or short-term capital gains.

Trading is taxed as a normal business. However, you are also carrying on intra-day trading, wherein you are not taking or giving any physical delivery of shares. Such transactions are speculative in nature.

The following rules govern set-off of income from one head against another head of income:
a). Long-term loss if any in investment activity can be set off only against long-term gain.
b). Short-term loss can be set off against both short-term as well as long-term gain.
c). Speculative loss has to be adjusted only against speculative income.
d). Trading loss can be adjusted against any income including speculative profits or capital gains (both short term or long term).
e). Unabsorbed loss can be carried forward for eight years to be set off against the respective head.

It is advisable to keep separate accounts for the three activities to ascertain profit or loss from each activity.

Convert Stocks into Investment

I have been into trading of shares. If I discontinue this business activity and hold closing-stock-of-shares as investment, what would be the tax implications?
Stock in trade can be converted into a capital asset or vice versa merely by declaring the intention to do so and by supporting such an intention by adequate documents and by the way in which the transactions are recorded.

The differential tax treatment of any business activity when compared to an investment activity may prompt a tax-payer to redefine the activity in a particular manner in a given situation. This can be done to minimise tax liability.

While conversion of capital assets into stock-in-trade and taxability of resultant profit or loss is specifically dealt under Section 45(2) of the Income Tax Act there is no specific provision to deal with reverse situation involving conversion of stock-in-trade into capital asset or investment. Conversion of

capital asset into stock: Sale of converted asset results into capital gain or capital loss in the year in which such stock is sold. This is calculated by subtracting the cost at which the original asset was carried from the fair market value on the date of conversion.

Conversion of stock into capital asset: Based on the interpretations of various sections and prudence my comments are as follows:

Stock may be converted into investment in a running business or at the time of closure.
2. No capital gain would arise on the date of conversion. However when the investment is sold, it will result into capital gain or loss to be calculated taking book value as cost of acquisition.
3. In view of differential tax rates applicable on type of capital gain, period of holding of capital asset is relevant to distinguish long term gain from short-term gain. Period of holding in this case will be reckoned from the date of acquisition of original stock of shares.

This technique of converting stock into investment or vice versa can be effectively used as tool of tax planning.

Dividends in ELSS

Investments in ELSS schemes have a lock-in period of three years. Is this applicable to the dividends declared under the scheme as well? For example, if I purchase 100 units of any ELSS scheme on April 1, 2008, the lock-in period will be till April 1, 2011. If I am allotted 10 additional units as dividend on March 30, 2009, will the lock-in period be applicable to them also? Does it mean that the additional units can be sold only after March 30, 2012?

You are right about equity linked savings schemes (ELSS) having a lock-in period of three years. Once that period is completed, you can redeem your investment.

In the case of dividend reinvestment, the dividend declared is reinvested in the scheme itself. So it would be locked in for three years as well.

In case of dividend payout, the dividend amount is distributed to the investor and so no lock-in period is applicable on it.

Now let's talk about your example. You get 10 additional units on March 30, 2009. These units would be locked-in for three years from the date of reinvestment. So, you would only be able to redeem these 10 units post March 30, 2012. However, the units allotted initially can be redeemed on or after April 1, 2011.

Tax Implications on Scheme Transfers

After staying invested in a particular mutual fund for more than a year under the dividend payout option, I switched over to the growth option. I remained invested in the growth option for a period of two months and then redeemed my investment. What are the tax implications?

The dividend and the growth option constitute two different schemes of a mutual fund with two different NAVs. If you opted for a shift from dividend option to a growth option, it is actually an inter scheme transfer which is considered as a fresh investment in the growth scheme on basis of the transfer date's NAV. This transaction is similar to redeeming the investment manually from the dividend option and then investing the same in the growth option of a fund. There is no associated tax liability if an equity fund is held for more than a year. As you were invested in the dividend option of the fund for a period exceeding one year, there is no tax on the redemption amount which is transferred to the growth scheme (STT is deducted by the fund before paying you the amount). After the transfer, as you redeemed your investment after two months, you would need to pay a short term capital gains tax of 15 per cent on gains. This is to be disclosed when your file your income tax return at the end of the fiscal.

What's Dividend Stripping?

What is dividend stripping? Is it legal? Can I use it to save tax?

Dividends can be used to lower your tax liability. The proportion of tax you can save though is lower than it used to be previously and now comes with a caveat. Nevertheless the method is still useful. Let us explain how it works. Suppose you expect a mutual fund to declare a dividend soon, you can buy its units before the record date. When the fund declares a dividend, the NAV will go down, and that is the amount you will receive as dividend. And when the record date for dividend payment is over, you can sell these units. What you end up with is a capital loss and a dividend. Since dividend paid by equity funds is taxed only at 10 per cent (till March 31, 2003)—far lower than the 30 per cent you are likely to pay otherwise—the entire exercise will reduce your tax liability.

Here's a detailed illustration of how this works. Suppose you have a short-term capital gain of Rs 2 lakh during the current year and if you don't do any tax planning, you would pay approximately Rs 60,000 as tax. Alternatively, you could invest this sum in a fund that has an NAV of Rs 20, and declares a dividend of 50 per cent. This means that for each unit, investors

receive Rs 5 as dividend and the NAV goes down to Rs 15. For your Rs 2-lakh investment, you get Rs 50,000 as dividend. However, on the capital account, your investment of Rs 2 lakh is now reduced to Rs 1.5 lakh—a loss of Rs 50,000. Let us see how this affects an individual's tax liability. The amount of capital loss that you suffered in the second transaction will now reduce your original short-term capital gain of Rs 2 lakh to Rs 1.5 lakh. The tax liability on this amount will be Rs 45,000. In addition, you will have to pay a 10 per cent tax on the Rs 50,000 you received as dividend. Thus, your total tax liability is down from Rs 60,000 to Rs 50,000—a healthy saving of 16.67 per cent.

Of course, there are some flies in the ointment. You obviously will be exposed to some market risk since this exercise involves an equity fund—a dividend from a debt fund is taxed normally according to your income slab (till March 31, 2003). You also pay an entry and exit load that the transaction requires. Over and above that, you need to have a fair knowledge about funds' dividend declarations so that you can time your transaction. However, Budget 2002 tried to plug dividend stripping. It introduced a clause, which said that in order to offset any capital gain against any capital loss (owing to a fall in the NAV due to dividend declaration), an investor will have to stay invested for at least three months.

So, is dividend stripping legal? Yes it is. It may be an unintended consequence of the way the government has made tax laws, but it is not illegal. Since it is unintended, laws may be changed in the future to make it less rewarding. And this is what Budget 2003-04 did. This year's Budget proposes to make dividends from mutual funds tax-free in the hands of investors.

Indexation Benefits

Q. What is indexation? How does it help an investor?

A. Inflation—constant erosion in real value of money through a rise in prices—is a fact of life. Over the last few years though inflation in India has been relatively low—in the 3-6 per cent range. In the earlier years, inflation was generally on the higher side. The compounding effect

of even moderate inflation rates over many years can really depress the real gains you make on an investment. You may have made an investment that has quadrupled over the last 15 years, but the purchasing power of money is down to less than half of what it used to be when you made the investment. It is obviously unfair that the government should tax you on that portion of your gains that has actually been eaten away by inflation.

This unfair system of taxation continued till 1993, but now the government allows you to adjust your capital gains for inflation by applying an appropriate factor from Cost Inflation Index to the original price of units.

At the current rate of inflation, long-term gains made over a period—slightly longer than one year, but less than two years—generally don't benefit from indexation. However, there is a way of getting higher indexation benefit than is the case, usually by timing an investment properly. The inflation index for each year is applicable to investments that you hold on till March 31 that year. This means that if you buy an asset on or before March 31 and sell it on April 1 the next year, you will get the benefit of two years' indexation even though you have held the investment for 367 days, i.e, just over one year. Even for longer investments you can always get indexation benefit for one extra year by following this.

Q. How do you calculate tax on capital gains?

Short-term capital gains are subject to normal rates as applicable to other types of income. Long-term capital gains, however, are calculated after applying indexation and then taxed at 20 per cent. Further, in case of long-term capital gains on transfer of publicly-traded stocks and fund units, you have to first calculate tax as mentioned above. If the tax so calculated exceeds the amount arrived at by calculating capital gains tax— 10 per cent without indexation —then the excess has to be ignored.

Let's say that you have invested Rs 1 lakh in a mutual fund on March 30, 2001 and redeemed these units at Rs 1.2 lakh on April 1, 2002. According to the Cost Inflation Index levels announced by the government every year the cost of acquisition would be deemed to be Rs 1,09,901. Your long-term capital gain on this transaction is just Rs 9,901. The tax liability thus would be Rs 1,980.

Depreciation, a Tax Planning Tool

If I use my personal car in my agency commission business, can I charge depreciation on it?

Charging depreciation on personal assets put to use in a business can be used as a tax-planning tool. Let's see how this can be done.

1 Depreciation law permits you to charge depreciation on all personal assets, including your car, put to use in business. Common examples can be air-conditioners, mobile phones, furniture fixtures, personal computers or even a building for housing your office.

2. Normally, depreciation on capital asset is chargeable at rates prescribed under the Income Tax Act on the cost of acquisition for the first year and on written down value in subsequent years.

3. The Law is silent on the value to be considered for applying depreciation of such personal assets except building. Lawmakers missed out personal assets while laying down ground rules for charging depreciation of building owned by the assessee and put to use in the business carried on by him.

4. Explanation 5 to Section 43(1) of the I-T Act states: A notional depreciation is deemed to have been allowed over the years when the building was not used for business purposes. This deemed depreciation is reduced from the cost of acquisition to arrive at the value on which depreciation is to be charged from the year in which the building is used for business purposes. As a result, you are entitled to depreciation on reduced value.

5. As stated earlier, this provision covers only buildings. All other assets of personal nature can be charged on full original cost even if they are old.

Exchange one Asset with Another

My father purchased some shares of a company in 1997 and gifted them to me and my wife

jointly in September 2001. Since we are in the process of constructing a house, we sold these shares in August 2002 for utilisation of sale proceeds in the construction. Are we liable for any gift tax or capital gain tax on sale of the shares?

At the time of gift, no gift tax is payable by either you or your father, as the provisions of the Gift Tax Act are not applicable to any gift made on or after October 1, 1998.

The shares were purchased by your father in 1997, i.e. more than three years ago. Thus these would be treated as long-term capital assets even in your hands. The cost of acquisition would also be taken as that paid by your father in 1997 for acquiring the shares for the purpose of calculating the capital gain. Since you intend to invest the sale consideration towards construction of residential house, (assuming you do not have any other residential house in your name), you are not liable for any capital gain tax, provided you either complete the construction by the last date by which you are required to file your income tax return for the current financial year or else deposit unspent amount in Capital Gain Accounts Scheme to be utilised later on for construction.

In any case, you should complete the construction within three years of date of sale of the shares. In case you choose not to invest towards construction of house, you are liable to pay long-term capital gain tax. Further, you will not be entitled to the benefit of Cost Inflation Index factor for the period in which the shares were held by your father.

Taxation of Gifts & Arrears

1. Children's future

I have two children, aged 10 and 12. For the purpose of their higher education and marriage, I wish to keep some amount invested in their name by way of recurring deposits in banks, so that when they grow up they will be able to utilise the money for the above-mentioned purpose. I have been told that there is no gift tax on such transfers now. However, one of my friends told me that any interest received on these deposits shall be taxable in my hands. What should I do to fulfill my objective?

Your friend has said the right thing. Any income from the funds transferred by a person to his minor child is taxable in his hands. So, any interest earned on recurring deposits will be clubbed with your income and is taxable in your hands. However, you can invest in those schemes where the income arising from the investment is exempt from tax. Some of the investment avenues, such as Public Provident Fund (PPF), RBI Relief Bonds and some schemes of Life Insurance Corporation (LIC), are exempt from tax. In the case of investment in PPFs and LIC schemes, not only is the income not taxable, but you are also entitled to a tax rebate under Section 88 of the Income Tax Act.

2. Taxation on salary arrears

I am working with a corporation. I have received arrears for the last three years. On account of additional income from arrears, my employer has not only deducted TDS at the maximum rate applicable but also a deduction of Rs 8,000 has been made in the name of provident fund. I have decided to revise my returns and claim rebate under Section 89 of the IT Act. Can I claim rebate on account of deduction of PF pertaining to the years for which I have received arrears?

The IT Act provides relief to an employee if he receives arrears of salary pertaining to earlier years. The relief is in the form of re-computation of tax pertaining to earlier years on the basis of arrears of salary in those years. In this way, the tax for the year in which the arrears are received is re-calculated and the employee may get benefit of the tax slab in which he or she may fall.

However, as far as rebate under Section 88 for certain investments in PF, LIC, etc., is concerned, the IT Act clearly says that it shall be available only in the year of payment. Therefore, you cannot claim rebate on account of PF for previous years for which you have received arrears.

Tax Deducted at Source

1. TDS on prizes

Recently I won a car in a game show as a prize. The organizers of the show are now pressurizing me to deposit TDS for this car before handing it over to me. Is it not the duty of payer of an income to deduct tax? Also, since this is a car how can something be deducted from it?

Congratulations on your windfall. However, as the saying goes, you should not look a gift horse in the mouth. The law is very clear: all winnings from any kind of lotteries; prizes and cash awards won under game shows; entertainment programmes on television; incomes from crossword puzzles; and any other income from any games of any sort; or from betting or gambling of any kind is taxable income.

When somebody wins anything of this nature, whether it be in cash or kind, the organiser of the show or the game is supposed to deduct tax at source at 30 per cent, plus surcharge before handing over the prize to the winner. As far as your point about the difficulty of deducting something from a car goes, there is no distinction between prizes won in cash or in kind. Both are subject to deduction of tax at source. The organisers have to deduct tax at source in case the aggregate amount of winning is in excess of Rs. 5000.

In case the winning are in cash it is easier to deduct tax and pay the balance. However in case of winnings in kind the organisers responsible for handing over the prize may ask the winner to deposit the tax before releasing the prize. This is so because the ultimate duty of paying taxes is of the individual winning the prize. The organiser is only collecting and depositing tax on behalf of the Government. Pay your tax and then enjoy your new car.

2. TDS on Interest Paid

Our company has taken auto loan for the purchase of cars of the company. Do I have to deduct TDS on the interest component of the car loan repayments?

The liability to deduct TDS on the interest arises if interest payment exceeds Rs.5000 p.a. However, there is no liability to deduct TDS if interest payment is made to banks or public financial institutions. In my opinion, if your car is financed by an NBFC then you should

deduct TDS as per rules.

Tax Benefits on Housing Loan

We booked two flats—one in my name and another in the name of my wife. We also took two separate loans from our respective employers to part finance purchase of flats. We did this to build an asset by financing it out of the cheaper loan and the expected rental income. Now that the concession in the rate of interest is being taxed as a perquisite, will you suggest that we sell one flat and repay the entire loan?

I cannot comment on your query with accuracy since I do not have the financial details. Having said that, I would like you to calculate the net cash inflow on account of rental income after making following adjustments for tax benefits:

1. Interest actually paid up at the end of financial year, proceeding the year in which property is acquired/constructed, is deductible in five equal installments starting from the year in which the house is constructed/acquired.

2. Once the property is acquired or constructed, interest payable on the housing loan is deductible in full in case of rented properties. In case of self-occupied properties, the upper limit is Rs 1,50,000 per annum.

Transfer of Property

Does transfer of house property require compulsory registration of the documents? I have to give away my share in immovable property in favour of my brothers under a family settlement. What shall be my income tax liability?

Transfer of property under a gift or will do not amount to transfer under income tax for the purpose of levying tax. Supreme Court held in Ram Charan Dass v. Girija Nandini Devi, that any transaction consequent to a family settlement entered into by the concerned parties to put an end to family dispute amongst themselves does not amount to transfer for the purpose of

capital gain.Since there is no transfer of property, no capital gain tax is to be paid under the Income-tax law.

However a contradiction arises on account of Transfer of Properties Act 1882 read with Registration Act 1908, wherein release of interest, in immovable property under a family arrangement, by the owner to another persons constitutes "transfer" and a written document evidencing the arrangement is to be registered with the authorities if the value of the transaction exceeds Rs. 100. The deed must be submitted for registration within four months of execution to avoid fine and inconvenience.

Gift Tax and Clubbing of Income

I am unable to invest properly in the names of my wife and other family members as the clubbing provisions of the tax laws mean that income from such investments gets clubbed with my taxable income. Could you explain clubbing and how to avoid it?

Gifts are a universal way to show love and affection to your family members and friends. The Indian government realised the merit of gifting, and stopped taxing gifts in 1998. No tax is to be paid on gifts while your loved ones enjoys the gift as well as the income from that gift.

Having said that, let me hasten to clarify that the above statement will not apply if the recipient happens to be your spouse. Interest or any other income, earned by your spouse from gifts is to be included in your income for tax purposes. Shocked? Bet you are. Paying taxes for someone else cannot be an expression of love or affection but the tax law does consider it so. The only exception is if you are separated from your spouse and the transfer is in connection with the agreement to live apart.

These measures have obviously been taken to stop tax evasion by falsely showing gifts. The transferor is liable to pay tax on income from the gift in the following situations:

l. Transfer of income without transfer of underlying asset. For instance, you are the owner of a house, which is rented out. You may arrange that the rent be paid to your spouse, parents or sister for their benefit, but the taxman will add the rent to your income and tax you on it as

the asset is still owned by you.

2. Transfer of income producing assets is revocable within the lifetime of transferee. In the above example, you may transfer the house along with the income, but if this transfer is reversible, the income shall still be taxed as your income.

As always, the onus of satisfying the assessing officer on these counts is upon you. In addition, the following types of transactions will also attract clubbing. These are specific to your spouse and your daughter-in-law.

a). Income from assets transferred to daughter-in-law.
b). Income from assets transferred to any third person for benefit of spouse.
c). Income from any assets transferred to a third person for the benefit of daughter-in-law.
Even the capital gains arising from sale of such gifted assets by the spouse get clubbed in your hands. (Dalmia vs CIT (1982) 133 ITR 169(Del).)

Here's how you can beat clubbing:
a). Gift to major son or daughter, or to son-in-law. Gifts to minors are always clubbed. Incidentally, this means that if you want to create wealth for your children, only gives them assets that will generate income after they turn major.
b) Gift to grandchildren.
c) Gifting away tax-free income bearing instruments such as RBI Bonds and other tax-free bonds.

Interestingly, investments from money received by the wife for household expenses are not clubbed as it is considered to be her income. If your wife's taxable income is lower than yours, give her money for household income and let her save out of it!

Physical Gold or Gold ETFs: Which is Better?

I am planning to invest in gold, but unable to decide on whether it should be an ETF or physical gold. Please throw some light on the ETF/Gold Funds that can be chosen. The investment amount would be around Rs 1 lakh.

With the rising gold prices globally, investors have benefited off late by investing in this asset class. Gold exchange traded funds (ETFs), many of which were launched last year, have made investment in physical gold easy. These funds have various advantages when compared to direct investment in physical gold. The units of such funds are traded on a recognized stock exchange and there is no associated wealth tax liability if you hold units of a Gold ETF.

During last one year, Gold ETF's have emerged as the second best performing category after Equity Banking with returns of 24.68 per cent (as on April 25, 2008). There are currently six gold ETFs in the market, with only two having a performance history exceeding one year. Apart from investment in an ETF, there is a fund — DSP ML World Gold Fund which invests in stocks of international gold mining companies. The fund has generated an astounding return of 38 per cent in the past nine months. AIG has also launched a fund on the similar lines.

Dependants' Insurance Premium

I pay premiums for my wife's and daughter's life insurance premiums. Overall the amount is Rs 45000 annually. Can I claim tax exemption on this amount under Section 80C? Can I claim exemption under any other section of the Income Tax Act?

Yes, you can include this amount while computing your total savings under Section 80C. There is no other section in the Income Tax Act under which you can claim exemption on insurance premium paid for other family members.

Arbitrage Funds

The market is very volatile at present and NAVs have sky rocketed in a short span of time. I am a first-time investor and can take moderate risk. Is there any good equity fund which can take care of a severe correction in the near to medium future? I want to invest in safe funds.

Arbitrage funds are an option you can consider at this time. If you are looking at a low-risk portfolio, you could consider investing a major part of your

portfolio in such funds. These funds try to capitalise on the arbitrage opportunities arising out of pricing mismatch of stocks in the equity and derivative (Futures and Options) segment of the stock market. They are an ideal way to get a decent return with moderate amount of risk. Funds like JM Arbitrage and SBI Arbitrage Opportunities have generated return in excess of 9 per cent in the past one year (as on December 19, 2007). You can enter these funds anytime and not worry where the market is headed. Since these funds invest predominantly in equities, they are treated like equity-oriented mutual funds and have the identical tax treatment. They attract a lower short-term capital gain tax of 10 per cent and become completely tax free if you hold them for a period exceeding one year.

Simultaneously, you can consider opting for some balanced funds. Balanced funds have significant exposure to debt, which makes them less aggressive when compared to a pure equity fund. You can consider five- or four-star rated balanced funds like HDFC Prudence, TATA Balanced or DSP ML Balanced for this purpose. Ideally, invest in these funds via a systematic investment plan(SIP) so that you are able to average out the cost of your purchase.

Are Derivatives Profitable?

What are derivatives? Is investing in derivatives profitable? What is the minimum investment amount required? Do mutual funds invest in these products?

Introduced in 2000 by the National Stock Exchange, derivatives are a different breed of financial products whose value is derived from an underlying instrument-such as an index, a stock, a currency or a commodity. Thus, instead of directly investing in a stock, you invest in an instrument whose value is dependent on the price of that stock. Futures and options are two popular and actively traded derivative instruments in the Indian stock market.

A futures contract is an agreement between the buyer and the seller for purchase or sale of an asset on a future date at a pre-determined price. One can enter into a futures contract by paying the margin money to the stock exchange. The position in futures is settled every trading day and is called mark-to-market. This means that the margin requirement will change every day with the change in value of the underlying asset. Futures can be both stock futures (stock as the underlying asset) and index futures (index as the underlying asset).

Now let us explain this with the help of an example. Mr A buys Nifty futures at 1250, and will make a gain if the Nifty moves above 1250. Say, the index moves to 1300, then the Rs 50-gain will be added to his mark-to-market account. Conversely, if the Nifty moves down to 1200, the Rs 50-loss will be deducted from the mark-to-market account. Similarly, if Mr A sells Nifty futures at 1250,

he will benefit from the downward movement of the index and will suffer a loss if the index moves up.

An option means the right to buy or sell. So an option too is a contract between the buyer and the seller for purchase or sale of an asset on a future date, but unlike a future, it is at a pre-determined price. The buyer of the option pays a premium to own the option, but he is under no obligation to honour the contract. In contrast, the seller has the obligation to honour the contract when the buyer exercises the option.

In volatile times, derivatives can be used as an effective hedging tool. Any gain or loss in the original portfolio will be offset by a similar loss or gain in the derivative product used to hedge a portfolio. But if derivatives are used as a speculation tool, it could be risky.

Put simply, derivatives are complex in nature and retail investors may not understand the risk they bring to the table. There is a risk of mis-pricing or improper valuation of derivatives and the inability of correlating derivatives perfectly with the underlying assets, be it stocks or indices. Further, derivatives are highly leveraged instruments. A small price movement in the underlying security could have a big impact on the value. Adverse price movements, on the other hand, in the underlying asset can either mean phenomenal gains or it could lead to the erosion of the entire margin money. Due to these inherent risks in derivative products, SEBI allows mutual funds to invest in derivatives only for hedging purposes, and not for speculation.

The minimum investment in derivatives depends on the type of instrument. The minimum lot size of the Nifty future is 50. Hence, if the Nifty is at 5000 points, the minimum value of 1 trading lot would be 50X5000 = Rs 2,50,000 (though only initial margin required for entering into a future contract and premium in case of buying an option). But for stock futures and stock options, the minimum trading lot varies among stocks. As a retail investor, if you want to benefit from the hedging benefits that derivatives offer, you can look at mutual funds that offer such hedging.

Calculating Annualised Returns

In a portfolio, how does one calculate Annualised returns? I would like to know the mathematical formula used, especially in a complex case such as:
1. SIP
2. Partially realized gains
Please try to explain each with an example.

At Value Research, we use two methods of computing fund returns over a period of time. Returns of fund's performance for a period of less than 1 year are Absolute Returns and that in excess of 1 year are Annualised Returns.

For Annualised returns, we use the CAGR formula i.e. Compound Annualised Growth Rate formula.
If an investment of Rs 5,000, made five years ago has grown to Rs 6,500 today, then the absolute gain would be Rs 1,500 - a 30 per cent growth on initial investment. A 30 per cent return on investment would normally qualify as good but for the fact that it was realized over five years. If you want to know how much the investment has grown on a yearly basis, you will have to take a look at the compounded Annualised growth rate (CAGR).

The CAGR tells you the return a fund turned in every year during the five-year period, provided the gains were re-invested every year. In this case, the CAGR works out to 5.38 per cent. So, in the first year the investment would have grown to Rs 5269. In the second year, it would have been Rs 5552.4 (by adding 5.38 per cent of Rs 5269) and so on. In India, mutual fund regulations require that all returns over one year should be stated in Annualised terms.

On our website, we calculate the returns for less than a year using the absolute method and those above a year as Annualised.

Kotak Launches Sensex ETF

Kotak Mutual is launching Kotak Sensex ETF on May 7, 2008. This exchange traded fund will track BSE Sensitive Index (Sensex) to provide returns before expenses that closely correspond to the total returns of the BSE Sensex. The fund is open for subscription from May 07, 2008 till May 16, 2008. The units would be listed on BSE to provide liquidity through secondary market.

This will be the second ETF on Sensex. The first ETF on Sensex was launched in January 2003 -- ICICI Pru Spice which has closely tracked Sensex and delivered returns as much as the Sensex in the past 5-years but currently has less than Rs 1 crore assets under management.

ETF is an Index fund but they trade on the market like stocks. Kotak Sensex ETF will facilitate exposure to Sensex with a single order. It will also enable trading flexibility by Intra day buying and selling just like any other listed share. The pricing will also be almost live as the intraday indicative price is likely to be closely linked to Sensex.

Index funds have lower cost as they charge lower management fee compared to actively managed funds. Investors will have to pay brokerage in buying and selling these instead of any entry/exit load.

Other Details:

- Each unit of the Kotak Sensex ETF will be approximately equal to 1/100th of the value of BSE SENSEX
- Entry Load during NFO: For investments < Rs 1crore 1%; For investments = > Rs 1 Crore Nil
- No entry load shall be charged on "all direct" applications received by AMC i.e., on application forms that are not routed through any distributor / agent / broker and submitted to AMC office or collection centre / investment service centre.
- Entry Load during continuous offer : Nil
- Exit Load Nil

Goats Are Better Than Monkeys

During the recent stock market carnage, two sectors that investors seem to be complaining the most about are real estate and banking. Many banks' stocks, even those of major banks have fallen by around 50 per cent. As I write this, SBI, HDFC Bank, and ICICI Bank are all down around 50 per cent from their one-year high points. However, real estate stocks have done far worse. The stocks of companies that were once pointed to as leading lights of the industry have fallen by 70 to 80 per cent or even more in some cases. Curiously, the fall in real estate stocks appears to have surprised many people far more than banks' declines have.

The reason appears to be that there are plenty of stories around that supposedly explain why bank stocks have declined. The agricultural loan waiver was one, the rise in interest rates is another and the subprime mayhem in the financial sectors in the US (and to a lesser extent, Europe) is yet another. Do these stories make sense? By themselves, they do, yet they don't add up to the kind of price decline that has happened.

Interestingly, unlike real estate, there are still buyers for bank stocks. Many mutual fund

managers for example, are happy that they can now buy bank stocks at far more reasonable prices. It seems that bank stocks are basically suffering from a stampede towards the exit from foreign investors who are now painting all financial stocks around the world with the same brush.

Investors in both these sectors are complaining loudly. So does that mean that bank investors and real estate investors are in the same boat? Not quite. Here's a story that will help you figure out the difference: One day a man appeared in a village and said that he would pay a thousand rupees for each monkey that the villagers could supply. The villagers caught all the monkeys in the neighbourhood and sold them to him. Soon a second man appeared and offered two thousand for each monkey. Since all monkeys were with the first man, the villagers had no choice but to try and return his money and take the monkeys back from him. However, the man refused. The villagers hiked up the price to Rs 1500 and then to Rs 1900 but he still refused. The villagers were at first puzzled by this refusal of the first man to make profits but they figured that there must be more buyers who were on the way to the village to offer higher and higher prices. So they hiked up the offer and bought back the monkeys for Rs 3,000. The two men then went away and the villagers then started waiting for more buyers. They waited and they waited but no one ever came.

Nearby, there was another village where exactly the same story happened, in the same way, except that the animals in question were goats. Here too, the villagers waited and waited but no one ever came to buy their goats at a higher price. However, there was a big difference. In the first village, everyone soon realised that the monkeys were a nuisance. They shouted and shrieked and bit people and were worse than useless. In the second village, the goat-owners were better off. The goats could be milked every day and the milk was good and healthy. When the goats eventually grew too old to be milked, the villagers could kill them for mutton.

Even though goats and monkeys had both been extremely overpriced, the goats turned out to be not such a bad deal. However, the monkeys were a complete disaster. The monkey-owners

had to eventually abandon the animals in the jungle and try and forget about their losses.

And that's the difference between having bought overpriced goats and overpriced monkeys. Just like the stock markets.

Fear, Greed and Panic

Over the last few days, the standard investing punditry that is available on business TV and newspapers has turned fiercely negative. The consensus view is that we're doomed. The line-up of problems that are going to ruin us all is impressive indeed. Oil prices show little sign of relenting. Not only is the inflation rate rising, but so are inflationary expectations and that's supposed to be worse. The government seems set to transition from a principle-driven ally that was blackmailing it to an unprincipled ally that will blackmail it. Growth is slowing down. There is a genuine fear in the air.

Among people who to invest in equities and equity-based mutual funds, the natural question to ask is what they should do now. In response, the best thing I can think of is to quote the great investor Warren Buffett. Buffett is fond of saying that one should be fearful when others are greedy and greedy when others are fearful. It sound like such an overly cute thing to say that you may feel that it's good only for printing on inspirational posters but actually, like everything else that Buffett says, it's deeper than it looks.

Clearly, others are fearful now. Does that mean that it's time to be greedy? It probably is. In a recent interview he said something very interesting in response to a question about what investors should do now that stocks have started declining. Here's what he said. “The answer is you don't want investors to think that what they read today is important in terms of their investment strategy. Their investment strategy should factor in that (a) if you knew what was going to happen in the economy, you still wouldn't necessarily know what was going to happen in the stock market. And (b) they can't pick stocks that are better than average. Stocks are a good thing to own over time. There are only two things you can do wrong: You can buy the wrong ones, and you can buy or sell them at the wrong time. And the truth is you never

need to sell them, basically. But they could buy a cross section of American industry, and if a cross section of American industry doesn't work, certainly trying to pick the little beauties here and there isn't going to work either. Then they just have to worry about getting greedy. I always say you should get greedy when others are fearful and fearful when others are greedy. But that's too much to expect. At a minimum, you shouldn't get greedy when others get greedy and fearful when others get fearful".

Just change 'American' to 'Indian' in these words and then read them carefully. It's so far removed from what most people think investing is all about that it takes time to figure out what this amazingly successful old man is saying. What he is saying that long-term success of investing is based not on the fact that the investor will be able pick the 'little beauties' but on the fact that country's economy is going to grow. What is happening now, (the short-term news flow) is not important because regardless of what you hear, what is happening in the country and the economy in the short-term may not be a good indicator of what is going to happen in the stock markets in the short-term. There are too many factors, too much noise, that affect the markets for the average investor to figure out.

However, in the long-term all the noise gets cancelled out and you are left with one single question. Is the country's economy going to grow? If you think the answer is yes, then that's a good reason to go ahead and own a broad cross-section of stocks. The bonus is that because it is a time when others are fearful, a lot of investments are cheaper than they were just a short while back.

The Comme Ci, Comme Ca Market

Quite simply, we have been in a bull market, which is dead (long live bull...!!!) The limited space allotted to me in this magazine does not allow me to prove this with facts, but I would point to the technical charts, with a sharp tooth at the end, to rest any arguments about that.

Just one little caveat before we proceed. The cost of carrying Dollar-funded positions is fast going to zero; and the cost of carrying Japanese Yen (JPY) funded positions, could be

negative. That is, you could borrow in JPY today at 2%, and pay 102 Yen to get a Dollar. A year later, you can have changed to Dollar at Rs.40, get back almost the same Dollar, and find yourself getting 110-115 Yen for the said Dollar. Since you only pay 2 Yen as interest, the balance would be profit. That is what I mean by negative interest.

Some smart people might be reading this article, and choose to do just what I have postulated above. If they buy the right Indian stocks, i.e. that did not run up during the recent bull run, or come out with IPOs, they might make a lot of money. Which stocks?! Ah, you will need to pay me some for that, what?!

To finish first, first you have to finish. I have long waited for this big spike downward, to start discussions on 'what next'. Even as people are veering round to the consensus view that this is the start of a bear market, I want to stand apart (as usual) and point out just how it's going to be 'different' this time.

I just don't have enough space to do it all in one breath.

Lay investors tend to think of markets in terms of bull and bear phases. Usually, this implies sharply rising or sharply falling markets. In actual practice, there is a third, widely prevalent category which I will call the range-bound market.

Bull markets happen either when there is a steep earnings upmove, or, more likely, there is a sharp rerating of valuations. While earnings across an economy rarely grow steeply, except in commodity economies like Chile, Kazakhstan or South Africa, in most broader economies, a bull cycle is triggered by a drop in the cost of capital and increase in the supply of funds to a market. The source of such sharp incremental supply (of funds) may be domestic savings, or international, but bull markets are usually started by what is actually a monetary phenomenon.

Bear markets, on the other hand, are usually triggered by bubble collapses, which convert euphoria into a climate of fear, with large paper losses all around. And actual bankruptcies in the over-exuberant retail day trading population. This reduces the velocity of money, market liquidity drops dramatically and conservatism sets in.

Then comes a long period of 'readjustment'. This is the grey area, which is usually misclassified by laymen as belonging to one or the other of the previous 2 classifications: either doubtful 'bull' or doubtful 'bear'. Actually, this is the range-bound market, what I call the comme ci, comme ca market. During this period, there is high volatility as Mr. Market tries to make up his mind, moving from bouts of mild euphoria to cautious optimism to down-in-the dumps and back again. This is the period you are seeing now. If you want to know where I am just now, I would think the middle (cautious optimism) just about describes it.

Just for the record we DEFINITELY are NOT in a classical bull market now, so let us set that debate at rest. With rising inflation, the outlook for interest rates cannot but be bullish. So, like I have been saying for a long time, Real Estate and other denizens of the bull should be RIP!

The difficult debate is about the bear market. We now hear numbers like 9000 as a forecast for the Sensex, which somehow tells that maybe now, that will not be seen (just because people have started talking about it). We are seeing a PE contraction, but it is still not clear that we are also going to see an earnings contraction, market-wide, at least. That is where the confusion lies, which makes it a stock picker's (and volatility trader's) paradise. You get to pick great multi-baggers with limited downside. Even as the cost of capital has risen, the cost of a mistake is dropping very fast.

History tells us that these (range-bound) markets make up almost 60% of the total time axis, with classical bull markets making up about 25% of total time, and bear markets making up the rest. However, since such markets are characterised by great Volatility, and that is synonymous with Risk. That is why these periods leave the average investor stone cold, either

asleep at the wheel or actively exiting the markets.

The ability to trade your portfolio average down to the market lows demands two special forebearances: one, that you were not part of the excesses of the bull market (see my column of Dec, 2006), which would leave you alive and still kicking around in today's chaos. So, if you were into large Real Estate cos or the power IPOs, I am not addressing you. Two, how much cash outside the market do you have just now, as a percentage of your Net Worth. Start nibbling steadily, and make the market pay for your book losses from now on. I would think that 50% of the excess is already bled and a trader who puts in 1% of his Net Worth with each 1% drop in the market cannot go wrong.

There are statistical techniques to ensure that your portfolio holding cost tracks the bottoms of the market, with a similar trajectory. These techniques do not maximise profits, but they do ensure that you cannot lose money in a statistically significant manner. If you operate with the objective of outperforming a stagnant market, redeploying your profits into your portfolio to wait for the inevitable upmove, you will not do too badly. You will, however, make some opportunity losses as the market turns up for a bull run. The attitude you should keep is another of the forebearances: that you do NOT seek to MAXIMISE profits, but merely to beat the cost of capital.

If you are right in your assumptions about the range-bound market, you will emerge from this market with earnings in the form of stock, a larger portfolio to ride the next bull market, whenever it happens. If you teach yourself to handle this well, you will stop celebrating even bull markets. Just develop a 'payback mentality' that focuses on retrieving cash from the market, without increasing your holdings till you have recouped the book losses on your portfolio.

This is part art and part science. Intelligent investors may write in to take help in learning more about stock selection, portfolio construction and 'beta monitoring', i.e. the monitoring of

your portfolio holding cost against the market bottoms and tracking the relative movement of your portfolio against the market averages. The major rules are the forebearances again: DON'T maximise gains, optimise return expectations, reinvest back into the market and save, save, save...!

Buying Funds Online

An investor who directly invests in a fund will not be charged an entry load. Can you advise me how can I buy and sell mutual funds online? Moreover, if someone invests in a mutual fund on the day the stock market falls significantly and sells on the day it rises, can he makes profit out of that?

Many asset management companies (AMCs) have started offering the facility to transact online via their websites. For this they have tied up with different banks to offer online transfer of funds. First, you need to ensure that your bank is on the list. Secondly, if you are creating a new folio or investing for the first time with a particular fund house, you would need to send the photo copy of your PAN card (this copy has to be attested by an authorized person). Once done and your folio is created, you can transact freely on the web to buy or sell funds in your folio. Do note that this procedure is applicable to a single fund house. The whole process is to be repeated while investing in a fund of a different fund house.

As to your second question, it is possible to buy and sell funds whenever you wish to. This can be done similarly as buying or selling shares online. The only thing you have to adhere to is the cut off time. Generally, if you successfully transact before 3 pm on a particular day, you would get the same day's NAV. After that time, you would be allotted units according to next business day's NAV. To be safe, check the cut off time on the company's website before investing.

Smart Investing: Beta Version

Say the word beta to a tech professional and an investor and each will interpret it differently. The tech professional will instinctively think of the software implication. Beta, as most of us would know, is the last leg of the software testing phase. It is not the final version of a product or website but close enough to show in public and work the bugs out. Now ask the finance professional or investor and he will immediately think of volatility. Simply put, beta is the measure of a fund's (or stock's) volatility relative to the market or

the benchmark.

Assume a fund is benchmarked against the Sensex. A beta of more than 1 implies that the fund is more volatile than the market. A beta of less than 1 implies lesser volatility.

Let's say that there are two funds, one with a beta of 2.5 and the other, 0.4. If the market rises 1 per cent, the fund with a beta of 2.5 will rise by around 2.5 per cent and the fund with a beta of 0.4, will rise by 0.4 per cent. The similar relationship will take place in a falling market. So beta is a quantitative measure of the volatility of a fund or stock relative to the market.

Beta & You

Essentially, beta expresses the fundamental tradeoff between minimising risk and maximising return. A fund with a beta of 1 will historically move in the same direction of the market. A beta above 1 is more volatile than the overall market, while a beta below 1 is less volatile. So while you can expect a high return from a fund that has a beta of 2, you will have to expect it to drop much more when the market falls.

The effectiveness of the beta depends on the index used to calculate it. It can happen that the index bears no correlation with the movements in the fund. For example, if beta is calculated for a large-cap fund against a mid-cap index, the resulting value will have no meaning. This is because the fund will not move in tandem with the index. Being fairly straightforward, beta offers a lucid, quantifiable and convenient measure which makes it easy to work with.However, it has its limitations too. Beta is a historic tool that does not incorporate new information. For instance, a company may venture into a new business and assume a high debt level. Yet, the beta will not capture this new risk taken on. Since beta relies on past movements, it cannot be used for new stocks that have insufficient price history to establish a reliable beta.

Finally, beta is just an indication. It relies on past price movements which are not foolproof predictors of future behaviour.

Why Unemotional Investing Pays

The recent market slide has left me wondering – Why do so many investors (and fund managers too) repeat the same mistakes time and again? After listening to many of the regret stories, the reason was not difficult to decode – almost every investor allowed his emotions to precede his decision-making. And every story has identical theme -- investors becoming over confident and unrealistic with their expectations.

I have been following the day to day gyrations of the market to gain understanding of market trends and behaviours. The more I observe the more convinced I am, of the utter irrationality of many of these spasms. Few days ago, every sector of the market gained 1-2% in a single day. The next day, everyone was worried about the interest rates again, erasing the previous day's gains. How can the picture change so much on a day to day basis? What other factors are at work here? Are stock traders really as emotional as the market news reporting seems to imply, with all of its language about "fears" and "hopes"?

If most of the intra-day trading decisions are really as mercurial as they appear to me, I was wondering about new forces affecting the behaviour of investors and the market other than greed and fear, which have been around since the dawn of mankind. But emotion prevails as the key driver.

The loud noise created by the media (the crawling ticker through the day and live market commentary on television) leaves many investors regretting over missing a high-flying stock. We hear our co-workers bragging about minting money in the market rally. And curse our bad luck for having missed the trend. But those investor's who feel they missed out, also don't take the time to identify the up-and-coming stocks or investments themselves? Most of them allow their fear of missing out and their greed to catch up, move to the next dangerous step of acting on a "hot-tip."

Just because a friend or relative had hit the jackpot previously, doesn't prove their magic touch for times to come. Second, by the time most tips reach you, they're old news. Third, and most important, by following a tip you let your emotions sabotage a sound financial plan.

The other mistake investors make is chasing previous top performers. Eyes get big when you review the enormous percentage gains of the 1999-2000 winners. And the concern is that the best stocks, funds or sectors of the prior year often persuade people to climb aboard. Again, the fear of missing out and the greed of catching the bus, overrides sensible investment decision-making.

Did you hop into the series of Technology Funds launched in February this year? Did you think this sector was unbeatable based on past returns and media hype? Of course, Technology funds were the biggest success stories. And then there's the "can't lose in IT" crowd. How many people chose these funds to represent the bulk of their portfolio, that is

beaten down so badly too soon.

A third disturbing error that emotionally charged investors make is falling in love with their investments. Undoubtedly, long-term equity investment is handsomely rewarding. Maybe you have owned a fund or stocks for many years. Perhaps the fund was a winner for five years, but in the last three, it doesn't even keep pace with its Value Research's Fund Average. Or possibly, you can't stand the thought of taking a loss, determined to break even.

Despite the obvious need to sell your lemon, cut bait and get those proceeds in a higher value alternative, the average investor buys-n-holds at his/her own peril. On the other hand, smart investors set their objectives from individual investments and understand under what conditions they will sell.

There's nothing wrong with expressing our feelings about investing, so long as they don't interfere with the decision-

Make Money & Save On Tax

Except for Equity Linked Savings Schemes (ELSS), all tax saving investments are fixed return. It is interesting to see how in the peak of a bull run, fixed return investments are scorned by investors. Why park your money in a place that gives you a meagre return when the bulls are galloping ahead to give you 60 per cent per annum?

Go back to the five-year period from 1998 to 2002. The Sensex rose wildly and then fell to almost the same level. During these five years, your money would have stagnated in the stock market. If, instead, you had invested in a fixed deposit where you were earning 11 per cent or 12 per cent per annum (which was the rate then), you would have seen your money go up by about 75 per cent.

However lucrative the stock market, it is risky. So in every portfolio it makes sense to allocate some amount of money to fixed return instruments. And, if you can avail of the tax benefit while doing so, so much the better.

Five-Year Bank Deposits

Lock-in period: Minimum 5 years

Safety: High

Instrument: Fixed return

Annual return: Depends on market interest rates

Limit: None

This has been the latest addition to Section 80C. And, for those who love depositing money in the local bank, this one is a real boon. But do make careful note that any deposit with a tenure of less than five years will not be valid for the tax benefit.

As of now, you can expect around 8 per cent on such a deposit. Senior citizens will get 0.5 or 1 per cent more. So while this option scores high on convenience and safety, the hitch is that interest earned on bank deposits is taxed.

Public Provident Fund

Lock-in period: 15 years

Safety: Highest

Instrument: Fixed return

Annual return: 8%

Limit: Rs 500 (min) to Rs 70,000 (max) per FY

Though its interest rate has dropped from 12 per cent to 8 per cent per annum, it is still the darling of the tax saving instruments.

To add to its sheen, it also boasts of the exempt-exempt-exempt criteria, popularly referred to as EEE. What this means is that there is a tax exemption on contributions (when you deposit money), tax exemption on interest earned and tax exemption on withdrawals.

It can't get better than this though it can certainly get worse. In the future, the taxation methodology would shift to EET -- exempt-exempt-taxed -- which means that the withdrawals would be taxed.

National Savings Certificate

Lock-in period: 6 years

Safety: Highest

Instrument: Fixed return

Annual return: 8%

Limit: Rs 100 onwards. No upper limit

On the face of it, this one is identical to the PPF but with a lower tenure. While NSC offers the same interest rate of 8 per cent per annum, it is computed on a half-yearly basis, while PPF on an annual basis. On this point NSC scores.

Let's say on April 1, 2006, you invest Rs 30,000 in both, PPF and NSC. A year down the road, you would have Rs 32,400 in your PPF account but Rs 32,448 in your NSC. As the years go by, the difference becomes all the more pronounced.

But this benefit is nullified when you take the tax benefit of PPF into account. The interest you earn on NSC is taxed but is also eligible for a deduction under Section 80C.

Generally, it is advisable to declare accrued interest on NSC on a yearly basis. So, over the period of six years, you could declare the interest income for each year. In such a case, it does not amount to a huge sum. If the above does not appeal to you, then you can claim the entire amount in the year of maturity under Section 80C.

While PPF is an ongoing account, NSC is a one-time investment available in denominations.

Get Tax Savvy

In **Make Money & Save On Tax** we showed you all the fixed-return tax-saving options. But blindly investing in one or two of them will not do you any good.

Other than fixed-return, we also have the Equity Linked Savings Schemes (ELSS) which are mutual funds that give a benefit under Section 80C. These have a three-year lock-in and give higher returns than its Section 80C peers.

You need to figure out how much of your tax-saving investment must be allocated to fixed return. There is no standard answer and you have to take a look at your investment portfolio.

Let's say that it is your first job and you want to invest for the long-term. Since you have age and time on your side, the best investment would be the equity-linked savings schemes. Of course, it is always good to also have a fixed-income instrument in your portfolio and if you are a salaried employee, then your PF would give you that option. If no provident fund is

available, then opt for PPF.

If you have already invested in mutual funds or in the stock market and have no fixed-return investment, then bypass ELSS as a tax-saving option. If you have only fixed return investments, then maybe you could allocate most of your tax saving to ELSS.

If you are close to retirement, then just a small portion must be allocated to ELSS and neither would PPF make sense with a huge lock-in period.

Once you decide how much to allocate to fixed return instruments, the next step would be deciding which fixed return investment to opt for.

A debate always rages between PPF and NSC. Over here, the timeframe will be the main consideration. NSC is only a six-year investment as against the 15 years for PPF. So if you need the money much sooner, then NSC scores. However, if you are looking at a long-term investment that you can stash away for retirement, then PPF is the best option. If you invest Rs 70,000 every year in PPF for 15 years, you will end up with more than Rs 22 lakh.

Or, if you have surplus funds in spite of touching the Rs 70,000 limit of PPF and you want a fixed-return investment, then NSC would be the next logical choice. If you are looking at the shortest tenure, then you also have infrastructure bonds (3 years onwards) and bank deposits (5 years) to choose from. The interest rate from these investments should hover around 8 per cent, the same as NSC.

Play it right

To be a smart investor, you must realise that tax planning is a year-round event and not something to be shelved till March. The best time to plan your tax investments is at the start of the financial year to help you take maximum advantage of opportunities to reduce your taxes. Especially if you are going to invest periodically.

Where investments like ELSS are concerned, it makes sense to allocate a fixed amount to them at the start of the year. Every month, with the help of a systematic investment plan (SIP), allocate a small portion to your fund. You need not buy your NSCs at one go either. With PPF, you have the option of 12 deposits in a year. Where bank fixed deposits are concerned, you can open them during the year at different time frames. Let's say you decide to invest Rs 20,000 in a five-year bank deposits. If you have just Rs 10,000 available to invest at

the start of the financial year, you can go ahead and open a five-year bank deposit. Six months later, when you do have surplus cash, you can invest the balance Rs 10,000.

So you don't need to have all the money at the start of the financial year to make your investments. Do them as the year progresses but plan for them at the start.

Non-Resident (External) Account

1. My son has been working in Indonesia for over a decade. Now, he's planning to return to India. If he makes a fixed deposit in NR(E) a/c for three years, before becoming an Indian resident, would the interest on that continue to be tax-free till the maturity of the deposit?

The interest on Non-Resident (External) account is fully exempt from income tax, provided, either the account holder is a resident outside India, as defined in FEMA, or a person who has been specifically permitted by the RBI to maintain the aforesaid account.

Since your son plans to return to India and settle here, he would become a resident in India within the next financial year. Tax exemption on interest, currently available, would lapse and the interest earned on the deposit in NR(E) account would be taxable in his hands.

2. My husband is working in Ireland and enjoys NRI status. He has an NR(E) account in India. Can you tell me what will happen to his NR(E) account if he decides to come back to India for taking up employment here? For how long can he maintain his NRI status?

A NRI account holder returning to India for taking up employment or for any other purpose, indicating his intention to stay in India for an uncertain period loses NRI status. He shall be a resident in India and his NR(E) account will be renamed as Resident Rupee Account or converted to RFC account, provided he is eligible for that and if he or she wants to convert the account. But if the account holder is on a short visit to India, the account will function as an NR(E) account.

For funds held in fixed deposits in NR(E) accounts, interest will be payable at the rates originally agreed upon, provided the deposit is maintained for the full term even after

conversion into a resident account. Your husband can maintain the NRI status if his stay in the country is for less than 182 days in the concerned financial year, and doesn't take up employment or for any other purpose indicating his intent to stay in India for an unspecified period.

NRI Corner

With India being one of the most promising emerging markets, non-resident Indians (NRIs) have a keen interest in being part of the Indian growth story. Here are five questions that NRIs tend to grapple with.

Can NRIs invest in mutual funds?
Yes. NRIs can invest in mutual funds in India. But they must do so in Indian currency. The money should be channelised from an account specially designed for NRIs. But all investors, including NRIs, need to have a permanent account number (PAN).

How must one invest so that the money can be taken out of the country?
Payments can be made by inward remittance through funds held in the Non-Resident (External) Rupee Account (NRE) and the Foreign Currency Non-Resident Account (FCNR). Indian rupee drafts can also be purchased from these two accounts and submitted with an account debit certificate from the bank.

NRE accounts must be maintained in Indian rupees but must be opened with funds remitted from abroad. The account can be in the form of a savings or current account or a recurring or fixed deposit. Money can be transferred out of India and interest on income is free of income tax. FCNR accounts are opened and maintained in specified foreign currency: Dollars (US, Canadian, Australian), Sterling Pound, Japanese Yen and Euro. This account can only be held in the form of a term deposit. Just like the NRE account, interest on income is tax free.

How does on invest on a non-repatriable basis?
NRIs wanting to invest on a non-repatriable basis can do so through a Non-Resident Ordinary Rupee Account (NRO). This is a rupee-denominated account and can be in the form of a savings or current account or a recurring or fixed deposit. This account can be held jointly with an Indian resident. What's interesting about this account is that the interest earned on it is repatriable, net of taxes.

What is the tax impact?
The tax treatment for NRIs is somewhat similar to that for resident Indian citizens. Tax is payable when the units of a fund are sold (capital gain) or

dividends earned. In the case of equity funds (those with an equity exposure exceeding 65 per cent), short-term capital gain is taxed at 10 per cent. This is for units sold within a year of being bought. There is no tax on long-term capital gain. For non-equity funds, the long-term capital gain is 10 per cent with indexation and 20 per cent without. The short-term capital gain is added to income and taxed at the relevant income tax slab. Dividends are tax-free in the hands of the investor. But a dividend distribution tax (DDT) is directly levied on a debt fund. The latter will make this payment out of the amount that is set aside for dividends. So in effect, the investor proportionately receives lesser dividend, but tax free. Equity schemes are exempted from DDT.

Can investments be done online?
Brokers like ICICI Direct, India Infoline and Share Khan allow you to buy stocks and mutual funds online. The flexibility of having an online account is the convenient monitoring of the portfolio and the ease of transaction. You need not fill a form or issue a cheque every time an investment has to be made. One just needs to place an order online and the amount gets debited from the linked account. The account opening and annual charges are not very high but are at a premium when compared to the rates offered for domestic investors.

Hidden Expenses

Free. The word evokes a different kind of feeling than what it actually means in today's world. Make no mistake about it, absolutely nothing is free today. Even things that are said to be free have a hidden cost to them. Wherever you read that four-letter word, the omnipresent 'conditions apply' will be there as well. You always pay for what you get, one way or another. A price for every product and a charge for every service. A doctor charges you for his services, a consultant charges you for telling you what you probably already know and in the same vein, a mutual fund charges you for managing your money.

The Expense Ratio is also known as Annual Recurring Expenses. This basket of charges comprises the fund management fee, agent commission, registrar fees and the selling and promotion expenses. The expense ratio is disclosed every March and September and is expressed as a percentage of the fund's average weekly net assets. A fund's expense ratio states how much you pay a fund in percentage terms to manage your money.

For example, let's assume you invest Rs 10,000 in a fund with an expense ratio of 1.5 per cent. This means that you pay the fund Rs 150 to manage your money. The expense ratio affects the returns you get as well. If the fund generates returns of 10 per cent, what you will get is just

8.5 per cent after the expense ratio of 1.5 per cent has been deducted. Hence, this makes it necessary for investors to know the expense ratio of the funds he invests in.

Since the expense ratio is charged every year, a high expense ratio over the long term can eat into your returns massively. For example, Rs 1 lakh invested over a period of 10 years would grow to Rs 4.05 lakh if the fund delivers returns of 15 per cent per annum. But when we deduct the expense ratio of 1.5 per cent per annum, then your returns come down to Rs. 3.55 lakh, down by almost 14 per cent over the period of 10 years.

Different funds have different expense ratios. However to keep things in check, the Securities & Exchange Board of India (SEBI) has stipulated an upper limit that a fund can charge. The limit stands at 2.50 per cent for equity funds and 2.25 per cent for debt funds.

The largest component of the expense ratio is the management and advisory fees. Then there are marketing and distribution expenses and all those involved in the operations of a fund like the custodian and auditors also get a share of the pie. Interestingly, brokerage paid by a fund on the purchase and sale of securities is not reflected in the expense ratio. Funds state their buying and selling price after taking the transaction cost into account.

Now that you know everything about expense ratios, let’s see if it really matters. The answer is yes, it does, especially in the case of debt funds. Debt funds generate about 7 – 9 per cent returns and any percentage of expense ratio becomes a substantial amount in the case of such low yields. On the other hand, in the case of actively managed equity funds, the issue of expenses is more complicated. The wide divergence of returns between ‘good’ and ‘bad’ funds makes the expense ratio secondary. However, if you are stuck between two similar funds, the expense ratio can be a good differentiator. But keep in mind, expense ratio is charged even when the fund’s returns are negative.

Overall, before you invest in a mutual fund, it is imperative that you check out the fund’s expense ratio. But remember that a low expense ratio doesn’t necessarily mean that the fund is good. A good fund is one that delivers good returns with minimal expenses.

Prime Concern

Usually, we explain an investment term here. This time around, we decided to explain a "lending" one - sub-prime. Sub-prime is now very much part of the

vocabulary of stock market investors and observers across the globe. They might have not known what it meant a few years ago, but they certainly do so now. And, it has managed to scare the living daylights out of them. The rest of them who do not know what it means are, nevertheless, quite certain that it is the cause of the recent global markets crisis.

Sub-prime loans are given to borrowers who do not qualify for regular loans. The reasons are either low earnings, bad credit history or both. Individuals in the US have credit scores ranging from 300 to 900. Creditors take different factors into consideration like payment history, delinquencies, bankruptcies, length of credit history, debt-to-income ratio, amount of credit, and type of credit when building a credit score. Though each lender has its own definition of what constitutes a sub-prime borrower, it generally is an individual with a credit score of less than 620.

Since the risk to the lender is higher, sub-prime loans always have a higher interest rate than a regular loan. They are mostly adjustable rate loans with a low rate of interest for the first two years. After that period, the rate can move up significantly. Such loans also tend to attract a prepayment penalty or a balloon payment, or both.

A prepayment penalty is a fee that the borrower has to pay should he pay off the loan before its complete tenure. So, if the tenure of the loan is 10 years and the borrower wants to clear the loan in the sixth year, a prepayment penalty is levied. A balloon payment will require the borrower to pay off the entire outstanding amount in a lump sum after a certain period. If he fails to do so, he will have to refinance the loan or sell the house.

At best, this is just a gamble. The borrower has got a loan despite evidence that he may not be able to make the payments. He would have put down very little money, if none at all. Should he have to sell the house, he assumes that the price of the home would rise during that time frame, enabling him to make a profit on the sale.

Though these loans are much tougher than those paid by the credit-worthy individuals, the size of this market is huge. According to an article that appeared in Fortune earlier this year, in 2006, 13.5 per cent of mortgages that originated in the US were sub-prime compared to 2.6 per cent in 2000. Overall, the sub-prime market was pegged at $600 billion in 2006, 20 per cent of the $3 trillion mortgage market.

Fund's PE Ratio

PE is the Holy Grail for equity investors. As an equity fund investor, how much importance should you give to this? Well, the answer is that you shouldn't assign as much importance as you would give to a stock's PE. Let's see why. For a company, a PE ratio tells you how much investors are willing to pay for one rupee of its earnings (profits). This can be seen from the definition of PE ratio.

It is the ratio of the share price of a company to its earnings per share (EPS). EPS is the profit that a company makes on a per share basis. So, if EPS is one, the PE ratio will reflect the price that an investor will pay for this one rupee of the company's profits. Because of this relation with a company's profits this ratio is also called the earning multiple.

Some shares have higher PE ratio and some lower. Higher PE ratio signifies that investor expectation from these shares is higher. This is because the growth in share price is expected to follow earnings growth. So, if investors are willing to pay more for a share, it is because they are expecting faster growth of profits. These stocks are often referred to as growth stocks.

At the other end are companies which have a low earnings multiple. Here, investors are not expecting much growth, and these stocks are called value stocks. The situation could change as a company that has been growing slowly can gather pace and a fast-mover can slow down. Growth and value are thus not static concepts.

What about funds? Well, first of all, an equity fund is a collection of shares. Therefore, a fund's PE is the average of the PEs of all stocks, in proportion to their presence in the portfolio. Because fund portfolios change, the PE will also change and this will not reflect the growth prospects of the underlying assets. A fund's PE is the weighted average PE of its stocks. Cash has no role to play. Thus, caution has to be exercised and the cash component has also to be factored in while looking at PEs. Similarly loss-making companies are assigned a zero value. For these reasons, a fund's PE is not as relevant as that of a share.

Nonetheless a fund's PE can be used for comparing funds in its category, or in comparing categories. If you are investing in a value fund, then expect the fund to have a PE lower than that of growth funds. Similarly, mid-cap funds will have lower PEs than large-cap funds. Thus, the three mid-cap funds, Birla Midcap, Franklin India Prima and Sundaram Select Midcap, had PEs of 10.83, 8.57 and 6.79, as on May 31, 2003. In comparison, the Sensex, which comprises 30 large-cap stocks, has a PE of 13.25.

Technology funds, on the other hand, have higher PEs, as technology stocks have high PEs vis-a-vis other stocks. Within this, the PE can be used to discern the stock selection of the fund manager. Thus, Franklin Infotech Fund—which strongly favours large and well-established technology companies—has always had one of the highest PEs in the technology

fund category. Funds such as Birla IT have seen greater variation in their earnings multiple as they have moved between large and mid-cap IT stocks.

Just as growth and value are not static concepts, the PE of a fund also will change. Thus, Magnum Contra, a value fund had a PE of 8.84 in April 2000. Today, as the value has been unlocked from many of its shares, the fund sports a higher PE of 11.44.

Hence, a fund's PE ratio can tell us whether the fund has more growth stocks or value stocks compared to another fund.

Expense Ratio

A wise man once said: "There is no free lunch on Wall Street." This holds true for investing in a mutual fund too. Like a doctor who charges you for his service, mutual funds too charge a fee for managing your money. This involves the fund management fee, agent commissions, registrar fees, and selling and promoting expenses. All this falls under a single basket called expense ratio or annual recurring expenses that is disclosed every March and September and is expressed as a percentage of the fund's average weekly net assets.

Expense ratio states how much you pay a fund in percentage term every year to manage your money. For example, if you invest Rs 10,000 in a fund with an expense ratio of 1.5 per cent, then you are paying the fund Rs 150 to manage your money. In other words, if a fund earns 10 per cent and has a 1.5 per cent expense ratio, it would mean an 8.5 per cent return for an investor. Funds' NAVs are reported net of fees and expenses, therefore, it is necessary to know how much the fund is deducting (expense ratio can be found in the half-yearly reports of the AMC or on valueresearchonline.com).

Since this is charged regularly (every year), a high expense ratio over the long-term may eat into your returns massively through power of compounding. For example, Rs 1 lakh over 10 years at the rate of 15 per cent will grow to Rs 4.05 lakh. But if we consider an expense ratio of 1.5 per cent, your actual total returns would be Rs 3.55 lakh, nearly 14 per cent less than what would have been achieved without any expense charge.

Different funds have different expense ratios. But the Securities & Exchange Board of India has stipulated a limit that a fund can charge. Equity funds can charge a maximum of 2.5 per cent, whereas a debt fund can charge 2.25 per cent of the average weekly net assets. The largest component of the expense ratio is management and advisory fees. From management fee an AMC generates profits. Then there are marketing and distribution expenses. All those involved in the operations of a fund like the custodian and auditors also get a share of the pie. Interestingly, brokerage paid by a fund on the purchase and sale of securities is not reflected in the expense ratio. Funds state their buying and selling price after taking the transaction cost into account.

Expense ratio matters especially in case of debt funds. Till last year, when bond funds were giving a whopping 14.5 per cent return, nobody cared about expenses. But that's history now. The days of double-digit returns are over. With an all-round reduction in interest rates, bond funds are expected to give a return of 7-9 per cent this year. Thus, in a low yield universe, every penny will count. And as expenses are deducted from the fund before calculating the NAV, it is likely to be a major differentiating factor among bond funds where returns vary marginally.

In case of actively managed equity funds, the issue of expenses is more complicated. The wide divergence of returns between 'good' and 'bad' funds makes the expense ratio secondary. But here too, if you find two similar funds, the expense ratio can be a good differentiator. Perhaps, more important is the fact that expenses are charged at all times. Whether a fund generates positive or negative returns, expenses are always there.

Recently, funds have launched institutional plans for big-ticket investors, where the expense ratio is relatively lower than normal funds. This is because the cost of servicing is low due to larger investment amount, which means lower expenses. Overall, before venturing into any fund just check out this important number. A lower expense ratio does not necessarily mean that it is a better-managed fund. A good fund is one that delivers good return with minimal expenses.

What is EPS?

ROA, ROE, ROI, PE, EPS... Welcome to the world of financial accounting ratios. Confusing for some and comforting for others, these tools can be highly effective in making investment decisions. Given their simplicity, a number-averse person too can use them. Significant amongst the lot is the concept of earning per share (EPS). Companies are required to report both, the basic and the diluted EPS in their financial reports.

What is EPS?
EPS is a measure to track the profitability and success of a company on a per share basis. It is a significant determinant of the price of a share. Mathematically EPS is the net profit or loss, less preference share dividends, divided by the weighted average number of shares outstanding during a period. The number of outstanding shares could vary owing to the company buying back shares, issuing fresh equity, conversion of debt to equity, etc.

At the same time a company often has other financial instruments floating in the market that could be converted into equity. This potentially convertible equity could dilute your holdings. In order to take these into account, the concept of diluted EPS emerged. The two quoted figures can be quite different and you need to know what your share in the earnings will stand at if all the options of dilution come into effect. Companies report trailing EPS which is the based on earnings of the past year. You will often come across terms such as current and forward EPS, these figures are based on estimated earnings of a company.

How do you use it?
Just the way an investment decision made solely on the price of a stock or NAV of a mutual fund, is deficient, stand alone EPS bears no meaning. It is used, primarily as a tool for comparison. At the same time you can't compare the EPS of companies functioning in different industries. In making an investment decision, one can analyse the rate of change in EPS in the last two quarters and compare this change to the EPS growth rates in the past three to five years. This would indicate if the company is on track in the current fiscal. As a tool for inter firm comparison, EPS gives you an indication of the return on investment made.

Limitation
EPS does not take into account the market price of a stock and its use is limited to gauging the earning consistency of the company. When analysing EPS you must also look at the price earning ratio as well.

Speculative Investments

Oh My God! Speculation!
"The stock market is nothing but speculation", often hisses my friend, who is a

leftist intellectual. And after he reads this he will be transformed into an angry and irritated leftist intellectual who will have to be placated over some liquid refreshments but that's OK because this whole routine is something we've been doing for many years now. However, that doesn't quite change the fact he firmly believes in this speculation business. That the stock market is nothing but speculation is an article of faith in some circles. The strange thing is that this belief extends to circles far wider than my friend's. Large swathes of the media, political and official circles believe this. Even though the so-called 'investing community' doesn't seem aware of this, this view permeates much of the general attitude in our country about stock investing. The curious thing is that few people are at all clear about the definition of 'speculation'. What exactly is this 'speculation' that stock investors are accused of and how is it different from non-speculation?

The dictionary lists the following words among the synonyms of speculation: conjecture, rumour, gossip, assumption, guesswork, hearsay and supposition. It's clear that the word has a bad reputation, but that doesn't help us figure out what is speculation and what is investment. One definition that's surprisingly common is that speculation is 'engagement in business transactions involving considerable risk but offering the chance of large gains, esp. trading in commodities, stocks, etc., in the hope of profit from changes in the market price.' Unfortunately, this is a somewhat circular idea that isn't much use unless one can define what is 'considerable risk'. In any case, at the end of the day, all investment hopes to 'profit from changes in market price' so that's not much of a distinguishing factor. In my view, the difference between an investment and speculation boils down to not what an investor does but to what he wants and what his level of knowledge is. Think about it. Someone tells you that X stock is going to go up and you go ahead and buy it without any further thought. By comparison, someone else could know everything about X, it's prospects, the industry, it's peers and come to the conclusion that it's a good buy. Clearly, the very same action, depending on how much an investor knows, could be intensely speculative or could be a carefully considered investment.

Speculation really is a state of mind, but unfortunately it's one which generally has poor self-awareness. Are you, in this sense, a speculator? Here are a few checkpoints. The more of these you answer yes to, the closer you are to being a speculator. a) You never try to balance risk between different investments. b) You buy stocks of companies without a clear idea of how their businesses work. c) You choose which new issues to invest in based on the ads of those new issues. d) You buy stocks because they've gone up. e) You sell stocks because they've gone down. f) You think a stock with a lower price is cheaper than one with a higher price. g) You think the previous checkpoint is a mistake. h) You answered yes to most of these checkpoints and yet you are sure you are an investor and not a speculator.

ETFs Are Not Just Gold Funds

I've recently realised that more than a few casual fund investors seem to be under the impression that the term ETF, which stands for Exchange Traded Fund has something to do with gold. Nothing could be further from the truth; it's easy to see that source of this misconception. In recent months, there have been a number of high-profile advertising campaigns for that are called Gold ETFs. These are funds that do with gold what normal funds do with stocks and bonds. If you'd like to invest in gold but are worried about quality and physical safety, these funds offer an excellent alternative. But as it happens all gold funds are ETFs and all ETFs that were widely advertised were gold funds and thus some investors have formed a notion that the two are connected. Nothing could be further from the truth.

Non-gold ETFs have existed for more than five years and while they are a niche, they form an excellent investment avenue in certain situations. In fact, the largest equity mutual fund in India is actually an ETF (Benchmark AMC's Banking BeES), even though the reasons for this particular fund being so large are due to its being a banking index fund rather than an ETF.

Exchange traded funds are mutual funds but are bought and sold like shares. When you want to buy or sell one, you go not to a mutual fund salesman but to a stockbroker. This route of buying a fund means that you need a demat account but if you already have one it's probably more convenient than the normal route of buying a fund. Unlike a normal mutual fund where you buy and sell units from the fund company itself, ETF units are traded on the stock markets between investors. However, the fund company arranges to absorb any excess supply of units that an investor would like to sell or create fresh units when the demand for units is large enough. As a result, unlike normal shares, the trading price of ETFs is not heavily impacted by any demand-supply imbalances. The price moves more or less in line with the value of the stocks in the underlying index on which the ETF is based. As is obvious from this description, ETFs are inherently very low-cost funds. While an actively managed mutual fund often deducts expenses of up to 2.5%, ETFs are generally in the 0.3% to 1% range. With compounding, this can build up to a significant difference over time.

ETFs are a good way for participating in the stock market for those who just want to 'buy the market', that is, buy an index fund. Besides low cost, their quick and guaranteed liquidity also make them attractive to many investors. The fact that they can be bought and sold throughout the day at a currently available price can be a better way of trading in the broad market than a normal index fund that is available only at day-end NAV. As time goes by, we'll probably see more and more specialised ETFs which seek to fill in particular niches. While the Gold ETFs are the first of this kind, as and when funds for other high-liquidity commodities become possible, they are more likely than not to be to be ETFs. ETFs mix of stocks' and funds' characteristics offer some unbeatable advantages.

A Fool and His Money...

My friend Sanjiv Pandiya, who writes some of the most interesting stuff that is being written nowadays about investing, is fond of using the word fool. But he doesn't do it the normal way - the way, say, a school teacher does. Instead, he imbues it with an enhanced meaning that makes it easier to understand the markets. For example, I remember him once saying that banks were the default suppliers of foolishness in the markets. This idea of foolishness in this special sense makes it easier to understand why markets behave the way they do. What exactly is this foolishness? I think it's best defined as what is not.

We've all heard of the Efficient Market Hypothesis, which says that financial markets are 'efficient', meaning that the prices of stocks (or other securities) reflect all known information and therefore incorporate the collective beliefs of all investors about the future. For the hypothesis to be correct, people must have equal access to all information and have rational expectations.

I think the kind of foolishness we are talking about is everything that is the opposite of all those factors that make the market efficient. It's a bit like heat and cold in physics. You could say that the flow of knowledge and rational expectations keep the markets efficient or you could say that it's the flow of foolishness that keeps the markets inefficient. Isn't that a problem? No, it isn't, most certainly not. Inefficiency is what keeps the stock market interesting and profitable. If the markets were as efficient as the hypothesis says, then those who can identify and mark out foolishness would make less money.

Therefore, a steady and limitless supply of foolishness is the greatest of assets. Foolishness is the life blood of the stock market. Without foolishness, we would be nowhere. Instead of worrying about how well companies are doing and how much the economy is growing, smart stock investors should instead worry about whether an adequate supply of foolishness will be maintained. I'm happy to inform readers that if present trends continue, they have nothing to fear.

Over the last one month, I have been roaming around this great country and have visited 17 cities and have met and talked to investors in each. Although most of the people I met had

disappointingly low foolishness levels, in each location there were at least some who showed great promise and gave me hope that the supply of foolishness to the stock markets is in safe hands.

It'll take just a few examples for me to convince you that my optimism about the future of foolishness is well-founded. One crucially important observation I made was that the most promising suppliers of foolishness use a different calendar than the rest of the country. I met people who thought the term 'long-term' in long-term investing meant six months. I also met those who thought it meant three months and some who thought it meant one month. These are not isolated examples, there are a large number of people in this country who use such calendars. However, the definition of long-term that gave me most hope was, "When there are profits it's short-term, when there are losses it's long-term".

Don't ask, I don't know what that means either.

Blind Men and the Elephant

Here's an old story that most of us have heard when we were children. A group of blind men want to know what an elephant is like and are taken to an elephant to figure its shape out for themselves. Each one touches a different part and thus gets a completely different idea of what the elephant is like. One touches its side and thinks the elephant is like a wall. Another one touches the trunk and thinks it to be like a snake. The one who touches the tail thinks that the elephant to be like a rope and the ears were like a fan and the tusks like spears and the legs like tree trunks and so on and so forth. The moral of the story is obvious. In some versions of this story the blind men become violent over their differences and beat each other up. The story is used to indicate that reality may be viewed differently depending upon one's perspective. The problem, of course, is not the blind men are all wrong but they are all correct, but only partially so.

During the last week, the stock markets have fallen sharply, losing about 5 per cent over five trading days. Right now, in newspapers and on TV channels, there are any number of blind men offering opinions about the elephant in the stock markets. Here are some of the more popular reasons. Worried about inflation and under pressure from the Left, the government will reduce duties on X and/or forbid the exports of Y and/or ban futures trading in Z and/or increase capital gains tax (either short-term or long-term) and/or an increase in the Securities Trading Tax and lots more. All of it sounds like reasonable fears and any one could come true. In recent months, generally when I talked

to big investors they seemed to be hunting for reasons to justify the rise in stocks. Now, they are desperately hunting for reasons to prove that stocks are going to fall. At the end of the day, the fact remains that after years of booming stock prices, everyone is nervous and knows that there will some kind of a correction and would like it be over and done with as quickly as possible.

Actually, the situation is a little worse than it was in the fable. There, the blind men kept their opinion within themselves and argued with each other and maybe broke each others' heads. But these blind men, the ones we are listening to now, are shouting at the top of their voices and there are multitudes who believe that the blind men can actually see the whole elephant. The real problem is that there is now a huge army of pundits who are professionally committed to explaining each hiccup in the markets by touching whatever part of the elephant they feel they are experts in.

One version of this story I found on the net has a twist. A clever man comes along when the blind are fighting and says that the elephant is a great tree, and on this tree grow leaves like great fans to give most wondrous shade and fan the breeze. And the branches of this tree are like spears to protect it. For this is the Tree of Creation and of Eternal Life, and the Great Serpent hangs still upon it. Unfortunately, it is hidden behind a great Wall, which is why it was not discovered until this very day. It cannot be reached by normal means. The expert then charges the blind for telling them what the elephant is really like and makes a neat bundle of money. The moral of the story is that anyone can describe an elephant to blind men but only some can make money out of it.

As for me, as a professional, full-time, card-carrying member of the tribe of blind elephant experts, I've resolved to not even try to find the elephant. All I'm going to do is to keep sniffing the air to make sure that I avoid the big stinking pile of you-know-what, whether of the elephant or of another animal traditionally associated with the stock market.