GUIDELINES FOR INVESTMENT DECISIONS

MINICASE

Q1. Jai Prakash is 45 years old and has an annual salary income of Rs. 900,000. He expects his income to increase by 10 percent per year till he retires at the age of 60.

Jai Prakash expects to live till the age of 80. In the post-retirement period, Jai Prakash would like his annual income from his financial investments to be 50 percent of his salary income in his last working year. Further, he would like the same to be protected in real terms.

Jai Prakash owns a house (on which all the mortgage payments have been made) and has Rs. 700,000 of financial assets. He wants to bequeath the house to his daughter and Rs. 15,000,000 to his son when he dies.

The current financial assets and the future savings of Jai Prakash are expected to earn a nominal rate of return of 11 percent per annum. The expected inflation rate for the next 50 years is likely to be 3 percent.

What proportion of his salary income should Jai Prakash save till he retires so that he can meet his post-retirement financial goals?

Q2. George Kurien is 30 years old and his annual income for the just concluded year was Rs. 750,000. He expects his income to increase by 10 percent per year till he retires at the age of 55. George expects to live till the age of 75. In the post-retirement period, George would like his annual income from his financial investments to be 50 percent of his salary income in his last working year. Further, he would like the same to be protected in real terms.

George owns a house (on which all the mortgage payments have been made) and has Rs. 2,000,000 of financial assets. Only a year back he was blessed with twins-a son and a daughter. On their first birthday he thought it was time he made some serious financial planning for the future of his family. He wants to bequeath the house to his son and Rs. 20,000,000 to his daughter when he dies. The current financial assets and the future savings of George are expected to earn a nominal rate of return of 9 percent per annum. The expected inflation rate for the next 50 years is likely to be 5 percent.

1. **What proportion of his salary income should George save till he retires so that he can meet his post- retirement financial goals?**

2. **If George wants to retire at the age of 50, to pursue other interests in life, what Proportion of his salary income should he save?**

Q3. When the Kurla Cricket Club sent out a request for donations to its past members, to its pleasant surprise, the response was overwhelming. They could collect a little over a crore and half rupees! And then followed the inevitable arguments. While it was agreed that most of the funds collected should be wisely invested in the capital market, there were fierce arguments between two groups on the investment strategy. One team led by Choksi, a veteran of the stock markets was of the opinion that it was futile to try to beat the market and any such attempt would only enrich the brokers. On the other hand, the other team led by the young Ritesh had no such inhibitions and believed in adopting some flexible strategy. After some fierce arguments, the club decided to allow the teams Rs.75 lakhs each for investment over a three year horizon. They however asked both the teams to consult you, a well respected investment consultant and follow any advice that you may give to them in this regard.

You find that Team Choksi knew exactly what to do and does not need any guidance. You think it fit to put some restraint on the ambitious Team Ritesh. You suggest that in view of the prevailing uncertainties, to start with, they should go in for a balanced portfolio with equal weightage for equities and bonds and change to a CPPI strategy if the portfolio makes a profit in any year. You also suggest an annual rebalancing of the portfolio as on the first of each financial year, based on the closing prices of the previous year. Lest the team fumbles on stock selection, you suggest that they should invest only in the equity stocks of HDFC Bank, TCS, Godrej Industries and Tata Motors. If in the course of rebalancing, fresh stocks need to be purchased, then such purchase should be confined only to shares of those stocks that performed the best during the completed year. Bond investment should be confined to only PSU bonds.

Both the teams follow your advice and make the investment on 1-4-2009. If the market prices turn out to be as follows, during the three years, what is the compounded annual growth rate achieved by each team? While working out, you may ignore fractional shares, commissions, taxes, interest on bonds etc. For the CPPI strategy, use the formula: Investment in stocks = 1.4(Portfolio value – 60 lakhs).

Exhibit

Closing price	Nifty	HDFC Bank	TCS	Godrej Consumer Products	Tata Motors
31-3-09	3021	973	539	133	180
31-3-10	5249	1933	781	261	758
31-3-11	5834	2346	1184	365	1248
31-3-12	5296	520	1160	480	275
Corporate action		Stock split from Rs.10 face value to Rs.2 face value-trading on ex-split basis from 14-7-2011	1:1 bonus-trading on ex-bonus basis from 16-6-2009		Stock split from Rs.10 face value to Rs.2 face value-trading on ex-split basis from 12-9-2011