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MONEY

What To Do At The Top? There is enough liquidity and a sizzling corporate performance to match. Bottom line advice: rein in your excesses. By Clifford Alvares

Five months after the sudden sell-off in May 2006, when speculation and over-leverage undid even some savvy investors, the market bounced back in quick time to its all time high. So swift was this recovery that most investors were left sitting on the fence, waiting for an opportunity to buy. As markets at all-time highs usually go, it's no wonder investors are returning by the droves. But behind the market's new milestone lies a note of caution: rein in your excesses.

Sure, there's plenty happening to warrant the confidence. Sure, corporate profits have been exceptional-indeed as good as it could get-and foreign investors continue to be charmed by the great Indian story, investing more than $4.3 billion (Rs 19,350 crore) in the last four months. Gross domestic product (GDP) growth rates have never been better at 8.9 per cent in the first quarter, driven by the booming manufacturing and steady services sectors. Sure, the Sensex is looking better each passing day.

But the truth is: valuations, that ultimate barometer by which you gauge whether the stock you buy is cheap or not, stands at 21 times trailing earnings for the Sensex. And that's not really cheap. "Let's not forget that the main strength of this market is foreign funds and strong liquidity," says R. Sreesankar, Head (Research), IL&FS Investsmart. But signs are the valuations are beginning to look a lot more expensive than say a year ago. "The valuations aren't that cheap," continues Sreesankar.

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Not Easy Now

The stiff valuation of this market does not make stock investing particularly easy for you. While a robust second quarter earnings has prompted brokerages to pull out their spreadsheets and re-calculate and upgrade the earnings estimates for the Sensex, these higher numbers have yet to make the market watchers feel comfortable enough. Even after the upgrades, the consensus earnings estimate for 2006-07 is somewhere around Rs 690-700. Motilal Oswal, in a report, reckons it more precisely at Rs

692 for 2006-07. But the all-important forward PE of the market at the 13,190 level stands at a lofty 19 times earnings. On the other hand, the market's historical average PE has been just about 15 times.

But despite the higher PE ratios, it's unlikely that the market will revert to its average mean because of the higher growth rates of the Indian corporate sector. Earnings in the latest quarter have been up 23 per cent for the Sensex stocks, which is higher than the market's price earnings ratio. So, analysts reason that the valuations are not all that out of sync. Says Nitin Raheja, Chief Investment Officer (Equities), Dawnay Day AV: "It all depends on what you look at in the market. Various sectors have contributed to the growth of the index at different times like banking now and it before this. It's backed by good reason."

Of Risks...

But the risk-reward ratio probably is still skewed towards stocks. Of course, stocks are volatile as they have been especially during the last few years. They are more volatile than bonds, though bonds are equally volatile than many investors seem to realise going by their price movements in the markets. But the real risk for investors is when long-term returns do not keep pace with inflation. Raamdeo Agarwal, joint Managing Director, Motilal Oswal, reckons that the investing now is still tilted towards equity as compared to debt, despite the recent run-up of the market.

Agarwal compares the price earnings of the current market with the 10-year bond valuations. A bond valuation can be figured out by dividing its price, say Rs 100, by the yield or interest it fetches. Currently, the 10-year government bond yield is around 7.5 per cent, which works out to 5.25 per cent post-tax for the 30 per cent tax bracket. If you divide 100 (the price of the bond) by its post-tax yield of 5.25, the 10-year bond PE would work out to 19 times. However, the one-year forward valuation of the Sensex also stands at 19 times. By that yardstick, Agarwal concludes that the market is not over-priced and over the distance can do well. "In a bond market, one can barely preserve the purchasing power of money," surmises Agarwal, "but with stocks one can."

...And Rewards

But the all-important question: what future returns can one expect? Over the last 10 years, the Sensex's rolling returns, which is the average annual returns generated every year as on October 2006, is about 20 per cent per annum. A bulk of this was generated in the last four years as the Sensex gave negative returns in the three preceding years before that. A combination of earnings growth as well as expanding valuations, as the PEs doubled from 10 to 20, have been major reasons for fabulous returns in the last four years.

Perhaps there's a reason for some of the stocks or sectors to do better than others. Some of it, for now, has a lot to do with laws of demand and supply and the stock market is no exception to this. Over the last one year, it was the big Sensex companies or the large non-Sensex companies that saw huge amount of inflows as the demand for liquid companies in which foreign investors could enter and exit easily were in great demand.

As of now, though, there's not much of an elbow room for an upward expansion in the valuations of the big companies. If all things remain equal, a PE expansion from the current levels of 21 to, say 25, will yield a return of 19 per cent, which is not that significant given that stocks are such risky assets. Besides, it means valuations will get to precariously higher levels. Says Manish Chokani, Managing Director (MD), Enam Financial Services: "The bigger stocks will probably not perform as well if there's just a steady expansion in earnings. It's better to focus on the pay-back from companies irrespective of what happens to the market."

Margin Of Safety

Perhaps a more significant strategy for an investor is to seek out those companies where there's a big margin of safety in both earnings and valuations, says Enam's Chokani. As markets go higher, picking the right stocks for your portfolio gets harder and it becomes increasingly difficult to outperform the market. So, Chokani advices to pick stocks that can double their earnings in the next three years where the valuations are lower. "This will give me a double comfort zone if anything should go wrong with the markets or future earnings. Over two to three years, it's a better way to go."

Think Long Term

What worries anybody, especially lay investors, are sudden sell-offs, such as the ones witnessed this May. These market crashes were essentially caused by a sudden offloading by global funds across the world. In less liquid markets such as India, they cause mayhem and the small investor begins to lose confidence. But if you play sufficiently for the long-term such short-term blips are the opportunities to grab.

Besides, the impact of short-term volatility due to any adverse news gets reduced over time. Says Raheja: "The best way to meet volatility is to invest for the long-term."

Diversify

It's the first defensive measure to follow in any market. With most stocks ruling at their all time highs, it becomes increasingly important to mix different stocks of growth that are reasonably valued without exposing your portfolio to a lot of risk. Some of the best moving stocks in the recent past have been the ones that are well-managed and are poised to grow by scaling up their operations and expanding into newer markets. Besides, this market has been awarding quality companies with higher valuations. So even if you are looking into the vast tier of mid-caps and small caps, shortlist only among those that have a sound management and a good business prospects going forward.

Hold Cash Too

Opportunities in this market come as quickly as they go. As the economy is doing well and some of the growth companies already discovered by the market, much of the future earnings is already priced in. So, it's probably not advisable to hold all your assets in stocks. Keep a little cash for those small buying opportunities that could come by chance, advises Chokani. He reckons it's good to keep about 20 per cent in cash.

The Complete Fund

If keeping tabs on different funds is a chore when all you need is simple asset allocation, a fund of funds may be just right.

By Mahesh Nayak

Navin Singh, 24, senior manager at a Mumbai-based BPO, is looking to make the best of this bull market, and yet play it safe with other asset classes. Having learnt that he should not keep all his cash in the equity basket, he's planning to diversify across equities and other asset classes such as corporate debt and gilt securities. But sifting through funds and narrowing down to a select few to complete his asset-allocation mix seemed like the proverbial needle in the haystack.

"About 85 per cent of returns depend upon the way assets are allocated" Mahendra Jajoo
Head (Fixed Income & Structured Products), ABN AMro AMC

Instead, Navin decided on an alternative option: fund of funds.

The basics

What is an FoF? A fund of funds is a mutual fund that invests in other mutual funds. It helps investors to invest in many types of funds (that include equity, debt or a mix of both) and different fund manager styles through just a single investment. So if you need a proper asset-allocation, it may seem like the way to go. "Investors can balance asset allocation in a more systematic way and therefore hope to give a superior outcome," says Mahendra Jajoo, Head (Fixed Income & Structured Products), ABN Amro AMC. "Historically, it's been proved that 85 per cent of returns depend upon the asset allocation. Through our FoF we plan to focus on asset allocation."

As risks can be diversified by investing in two-three different funds, an FoF helps to allocate between funds and thereby reduce risks and make the best of fund manager styles and asset classes. Another advantage is that you can save on loads. Entry or exit loads are charged whenever you invest in any fund, so if you choose three-four funds, you pay entry load that many times. On the other hand, entry load in a fund of fund is charged only once as most FoFs have a special service licence agreement (SLA) with fund houses where they invest. Among the early criticisms against an FoF were such double loads, but that's not a worry any more.

There's also the advantage of tracking at one place. Different funds need extensive tracking, each separately and that could get tedious. But here a single-window tracking should help you keep tab of your returns in one go. "In fact, people also tend to like such product because they want this one-stop shopping," says Jajoo. "Fund manager selection is also vital as performance of a mutual fund depends on it. If you select a good portfolio manager, you may be able to achieve higher returns." An FoF chooses a portfolio manager for you through a better understanding of the market and allocating to the right funds.

"Careful management is necessary for FoF to prevent holding overlapping securities"
Amar Pandit
Financial Advisor
Myfinad

For passive investors

For now, however, the tax advantages in a fund of fund aren't available like any other equity fund. Says Sandesh Kirkire, CEO, Kotak Mahindra AMC, "While FoF helps diversify, the tax structure isn't favourable." The

Kotak FoF invests in equity funds which have tax breaks, but the FoF that invests in them is considered a debt product and hence it attracts tax at 10 per cent for long-term capital gains and at the normal slab rates for capital gains.

Besides, diversity may not really be achieved if the underlying investments are similar. Says Amar Pandit, Financial Advisor, Myfinad, "Careful management is necessary for FoF to prevent investment in overlapping securities. If there's an overlap, performance will get hurt." Besides, an investor will pay a management fee twice. "The extra cost on account of management fees charged by the FoF does not make for a good investment," says Pandit. Over the longer term, till such time FoFs establish a track record, it will be tough to gauge them. Overall, the category has performed alongside the market (see Well Balanced).

But for the uninitiated into mutual funds, where choosing different funds and understanding allocations is unpleasant, fund of funds may be the answer. Even passive investors should find an FoF a welcome attraction. Needless to say, it took care of Navin Singh's asset allocation like a breeze.

Outward Bound, Ahoy!

Fancy that Google stock or an apartment overlooking the Thames? No sweat. Now you can buy both, thanks to RBI's new rules.

By Anand Adhikari

Long ago, investors could hold only Indian assets, in Indian rupees. Buy a holiday house in Goa or hold equity in Indian companies or own mutual fund units. Today's investors, however, can aspire for global assets in various currencies. They can buy shares of Google or Microsoft in dollars, or own Arcelor Mittal in euros. For close to three years now, the Reserve Bank of India (RBI) has allowed resident Indians to invest abroad and acquire foreign currency assets.

"As Indian market grows and wealth increases, people definitely want to start investing outside"
Ajay Srinivasan
Prudential Corporation Asia

Now, however, the RBI has enhanced the limits and added to the smiles of Indian investors. Central bank governor Y.V. Reddy recently increased the overall remittances limit from $25,000 to $50,000 (Rs 11.25

lakh to Rs 22.5 lakh), and expanded the scope to include direct investment in overseas equity, mutual fund schemes, real estate and all other capital transactions.

Overseas fund managers are delighted. For Asian fund manager Ajay Srinivasan, Chief Executive of $400-billion (Rs 18 lakh crore) Prudential Corporation Asia, this spells opportunity. "It's the right way to go. As Indian market grows and wealth increases, people definitely want to start investing outside," he says. Now, Templeton, Alliance, Fidelity, Schroders, AIG, Jardine, Aberdeen too are said to be eyeing the Indian investor's wallet.

"There is going to be more and better investment opportunities in India than overseas"
John Band
Cortex Advisory

Options Galore

Theoretically, investment across the international spectrum will result in diversification, reduction in the level of various risks and a possible increase in the overall returns in the long run. "It offers a good diversification strategy in the sense that investors can take exposure in sophisticated products abroad," says S. Swaminathan, National Head (Mutual Fund), IDBI Capital Markets Services.

But there's a whole lot of risks too. "You have to factor in the currency risk. If rupee appreciates, as it did in the last couple of years, investors will lose out," observes Moses Harding, Executive Vice-President, IndusInd Bank. For example, if you invested $10,000 in, say, an apartment at Rs 46 per dollar, the outflows would tot up to Rs 4.6 lakh. If the rupee appreciates to say Rs 44, when you remit the same $10,000 (assuming the same price), you would get only Rs 4.4 lakh in India.

Besides, investors are faced with other kinds of risks such as transparency and earnings growth. Swaminathan has a word of caution: "International markets are also vulnerable to earnings, inflation, interest rates, political factors, and currency risk."

But for those who are up to the challenge, especially the growing tribe of HNI investors, there are some opportunities available-a variety of sophisticated and specialised mutual funds. Feeder funds are also expected to make their way providing another investment avenue. Returns of some foreign funds are phenomenal-up to 74 per cent (see Mutual Funds: The Top Funds).

Assets On the Other Side
Weigh the opportunities and risks before investing overseas.

OPPORTUNITY
Overseas investments: Remittances scheme enhanced for resident individuals from $25,000 to $50,000 (Rs 11.25 lakh to Rs 22.5 lakh) per annum.

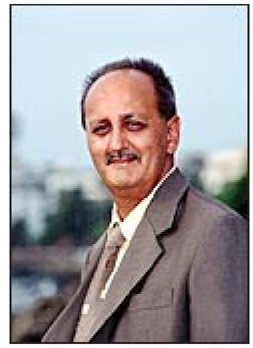
RISK
Currency risk: There's currency risk to watch for. If rupee appreciates you will lose money, all other things remaining equal. And vice versa.
Asset risk: As in any form of investing, the overseas assets you hold could tumble in value.

ADVANTAGE
Rupee diversification: For domestic investors, provides currency (dollar, euro or pound sterling) hedge if anything could go wrong with the Indian currency.

DISADVANTAGE
Transaction costs: The cost of transacting in global markets is high; brokerage and other maintenance charges higher.

Apart from mutual funds, yet another product available is the global fixed deposit in strong currencies such as us dollar ($), euro (m) and pound sterling (£). In the past, Citibank was the only bank in the country marketing these global fixed deposits. The RBI guidelines initially allowed only the fixed deposit option to domestic investors in view of fear of safety and security. But the deposits were not very attractive earlier because the US Fed rate was historically low at 1 per cent, though the rate now looks attractive at 5.25 per cent.

Today, Citibank offers 4.87 per cent interest rates for a six-month deposit in dollars. If you have a slightly longer term time horizon, you can earn 5.90 per cent in a Canadian deposit for one year. Pound sterling deposit of over a year offers 7.14 per cent, which is the highest. "Interest rates abroad are not very attractive for domestic investors. If one really has a very pessimistic view of the Indian economy, then the diversification into global markets makes sense," says a banker who did not want to be named.



"You have a bigger and probably better universe of companies to choose from"
Andrew Holland
Executive Vice President, DSP Merrill Lynch

As far as stocks were concerned, the RBI earlier allowed investment in multinational companies with Indian subsidiaries. Here again, though, the investor needed to have an appetite for risk and an urge to get a piece of global companies. But now stocks of Google and Microsoft can be easily purchased so long as they come under the overall ceiling of $50,000 (Rs 22.5 lakh) per annum. As you can imagine, the universe of stocks across the globe is huge. "You have a bigger and probably better universe of companies to choose from," says Andrew Holland, Executive VP at DSP Merrill Lynch.

Not So Soon

For now, with the Indian stock markets doing well, most investors prefer to own assets they know and understand. John Band of Cortex Advisory reacts by saying it doesn't make any sense to invest abroad. "Indian economy is growing faster than many other economies in the world. There is going to be more and better investment opportunities here than overseas," says Band. Harding, too, pitches in by saying, "when return on investment is much higher in the domestic market, why should one invest abroad and also take a currency risk?"

Valid point. In a bullish market or buoyant economy, people don't necessarily think of reducing risk and investing abroad. But sooner or later, the opportunity to diversify assets will be felt, especially as other foreign markets turn attractive. Says Srinivasan: "I think the time will come when people will want to diversify and look for opportunities abroad." Indeed.

High Sugar, No Problem
The new diabetes care policy fills a gap. Tip: Watch the premium.

By Shivani Lath

Are you a diabetic?
Now, worry less

If you are one of those one in eight people who can't stomach the sugar, and are paying huge drug bills and doing the rounds of laboratories testing blood and collecting reports, there's welcome news.

ICICI Prudential Life Insurance has launched a new diabetes insurance policy which covers diabetics. But like most other health insurance products, this does not reimburse the traditional way after submission of bills, but pays the sum assured at the time of detection of any diseases that strike as a result of the diabetic condition. The idea behind the product, says N.S. Kannan, Executive Director, ICICI Prudential Life Insurance, is that "diabetics are expected to pay three times the premium in a life insurance scheme simply because they suffer from an ailment that is pre-existing."

The diabetes care policy is designed to cover not just the type 2 diabetics but also the high sugar (pre-diabetes) patients in order to incentivise them to control the condition. The package, therefore, provides not just a reimbursement but an incentive scheme which provides the patients three free medical examinations a year at any of the Wellspring or Metropolitan laboratories, which the company has tied up with. "To increase the economic incentive, these laboratories will also collect the blood samples from the patients' homes for no charge," says Kannan.

The scheme works such that if a person shows that he has been able to control the condition (on various parameters determined by the doctors), he gets a 30 per cent discount on the premium of the next year, depending on the age and extent of control (see Diabetes Care).

"Only about 35 per cent of the sum assured is actually used for medical expenses"
N.S. Kannan
Executive Director, ICICI Prudential Life Insurance

The sum assured, which could be Rs 3 lakh, Rs 5 lakh or Rs 10 lakh, is paid out the moment a patient is detected with any of the six ailments-heart diseases, bypass, stroke, kidney failure, major organ transplant or cancer. The scheme also includes a 10 per cent rider, of the sum assured, to cover two complications that arise out of diabetes-eye defects that may need laser treatment or limb dysfunction that require amputation.

ICICI Prudential has also tied up with Wockhardt, Nicholas Piramal, Biocon and Johnson & Johnson to provide policyholders as much as a 25 per cent discount on oral drugs, insulin strips and glucometers. "We have also tied up with 75 gyms across the country which will give discount memberships to the policyholders," adds Kannan. The policy is available for a term of five years for people between the ages of 25 and 60, who already suffer from adult diabetes or impaired glucose tolerance (commonly known as high blood sugar).

The company also has a 10-year and 20-year general health plan called Health Assure to cover critical illness for normal people between the ages of 18 and 55, with the maximum age at maturity being 65. The minimum sum assured is Rs 1.5 lakh and the maximum is Rs 10 lakh.

In April this year, it launched a 10-year cancer care policy for people between 20 and 55 years, with a minimum coverage of Rs 5 lakh. The idea is to enable patients to get the money when they are detected with the disease, rather than on submission of bills. "We've found that only 35 per cent of the sum assured is used for medical expenses, while the rest is used by the family to meet related expenses such as travel," says Kannan. Meanwhile, let's hope the diabetes care policy actually encourages people to stay healthy.

Really Burns A Hole

Credit card debt is expensive. Pay up in full.

By Clifford Alvares

If you are using your credit card like it is ready cash, then you are headed for trouble. Just ask Sangeeta Nachnani. Generally choosy about spending big, Sangeeta bought clothes and jewellery worth Rs 65,000 last year for her wedding and charged it to her credit card. One year down the line, she is still paying off her dues. Worse, after shelling out more than Rs 20,000 in interest charges over the year, Sangeeta's dues have barely nudged down and she continues to owe a hefty Rs 52,000 on her card. Her total bill so far: Rs 85,000.

But her bill might rise further. Sangeeta has been using the revolving facility on her credit card, which allows her to pay a minimum of 5 per cent of outstanding dues. Revolving allows card holders to roll over part of the bill to the next month with a low repayment of 5 per cent, thus totting up huge interests costs, besides adding to the outstanding tenure.

Perhaps this is a familiar lament of most card holders. That three-by http://deadpresident.blogspot.com

-two-inch plastic in your wallet might appear as the most innocuous thing to use when you are out shopping. True, it's a handy tool if you know how to use it. But if you don't, credit cards can make you lose financial control, and in the bargain even cost you a bomb.

That's because the interest rate on the plastic card is a high 2.95 per cent per month, which might not seem like too much at first glance. But on a compounded annual basis, the usual way in which banks quote interest rate on loan products, the interest rate works out to a whopping 42 per cent per annum-more than four times a typical home loan interest rate or about twice that of a personal loan.

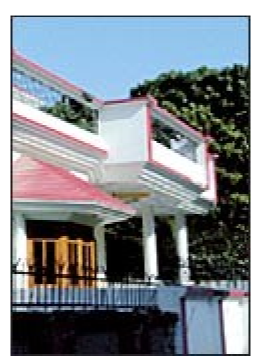
Besides, paying only the bare minimum of 5 per cent to keep your credit card going, could take years before you repay all your outstandings. A bill worth Rs 65,000 can take as long as 28 years to repay, at the minimum rollover levels of 5 per cent. Instead, the credit card balance that should be paid off in full gets stretched for years.

That's not all. It's not just the interest charges on the credit outstanding that you are paying. Cardholders have to pay an additional service tax of 12.24 per cent (including surcharge and cess), on the monthly interest costs. By adding that to the interest cost of 2.95 per cent, the actual rate shoots up to a high of 3.3 per cent per month, or, on a compounded basis, close to a whopping 48 per cent annum.

Of late, Sangeeta has upped her repayments from the minimum of 5 per cent to a fixed sum of Rs 15,000 every month and hopes to cut down to zero debt in about five months. To top it, she decided to use the free credit period of 45 days to the hilt, and pay up all new credit card charges in full. She's learnt the hard way, but she has learnt just the same.

SECTOR WATCH
Building Transparency

The draft housing policy spells more clarity for home buyers, but prices are unlikely to fall.



If there is anything for the home buyer in the recent Maharashtra government's draft housing policy, it is this: more transparency. Buyers can now be sure of getting a fair quote across projects and also of better quality construction. Builders, too, have welcomed the move. Says Niranjan Hiranandani of Hiranandani

Construction: "For the first time, we have a policy that talks about improving the housing situation holistically with clear timelines. It's a welcome policy."

While the draft policy outlines the housing road map of the state, it's unlikely that housing prices are going to come down. Additional development allowed in terms of an additional floor space index (FSI) has been very marginal in the suburbs, and is not going to add much to available space. Says Hiranandani: "The additional FSI issue has not been addressed, which was crucial for increasing space. In places where land would be freed and available, prices could come down." But generally, prices in most areas will move as per demand and supply.

Another clause will make it mandatory for builders to quote prices based on carpet area. Until now, they have been quoting super built-up and built-up area prices to make the housing prices appear affordable. Built-up area accounts for the house walls and super built-up for the staircase garden and other spaces. By including these, it would seem that the buyer is buying a larger area at better rate, which is not the case.

By compelling builders to quote the carpet area, which is the actual living area inside the house, the draft housing policy has made home buying transparent and uniform across builders. Says Hiranandani: "Earlier, we used to buy petrol by the gallon, now we buy it by litres. It's just an adjustment and won't change anything."