Managing your wealth: Simplicity is the best policy

by Rajmohan Krishnan, 16th May, 2017

Wealth Planning

HNIs often fall prey to sophisticated financial products. But the real experts know the value of keeping the portfolio simple.

It's natural for the ultra-wealthy to get attracted to innovative and new products which seem far removed from the retail investments made by the salaried class. Therefore, they often shun commonplace mutual funds, even if a particular mutual fund is the most transparent and well-constructed investment.

Innovation is sophisticated. It is sexy. Perhaps so in other realms such as fashion, technology and entertainment. In investments, there can be no substitute for simplicity. A simple portfolio can be navigated and de-mystified at will. Meanwhile, innovation (you could also say sophistication or complexity) can hide losses and risks. For instance:

The superiority of the FOIA model can be measured in three dimensions:

- A well-known Indian Wealth Manager ran a seemingly promising fixed-income product and leveraged it to take 3 times the invested amount as loan from their own NBFC at the rate of 11.5 to 12%. The assumption that the interest rates will climb down never materialized. Meanwhile, the investor paid a hefty commission and experienced a negative carry from day one.
- Quant products are supposed to be based on algorithms that benefit from past trends and data. However, new trends throw up new blind spots that are not accounted for in the algorithms, rendering their innovativeness meaningless.
- Certain investments are linked to market movements. If the market goes up, say, 15%, your investment doubles. If it plummets 20%, it will be valued at zero. With multiple such variants and the volatility of the global market, you can no longer forecast your revenue.
- Nowadays, certain derivative products claim a high return such as 25%. However, when one subtracts the 1-2% wealth manager fee, 2-4% carry and 30% taxation, the real return is just 13%. The situation is similar for certain real-estate funds with no exit options but loaded with management fee, profit sharing fee and taxes. In such cases, equity mutual funds might offer superior returns and more liquidity.
- Another example is a balanced fund where more than 65% of the investment is in Equity and 20-30% is in Debt. The client thinks it gives the best of both instruments. In reality, the whole product is treated like equity in terms of commission, and equity commissions are higher.
- Many High Risk Debt funds sound innovative, promising to wrap the risk of equity with the solidity of debt funds. As it happens, these funds are half as risky as equity and offer only 1-2% more returns than a standard debt fund.
- Positioning a fund to fit an investor's asset allocation is a common innovation practice. We had the experience of evaluating one such fund that was advised as an Alternate Asset fund to one client, a High Risk Debt fund to a second and as a Real Estate fund to the third. Clients not looking beyond reassuring labels miss the informative fine print.
- Sometime back, the market saw a long tenure fixed-maturity plan linked to an inflation index. The instrument promised a marginal return above the index return. Recent commodity crash has pushed this index into negative territory, and as a result, clients are hardly getting any return in this locked-in investment. So dastardly was this innovation that we circulated a note to our clients warning them that the index output was both volatile and ambiguous.
- A few years ago, a debt fund with underlying FCCBs of Indian companies was sold overseas. It has fizzled away causing anguish to investors. Sometimes, complexity is simply a geographical matter.

To counter these complexities, we urge investors to follow these simple rules:

1. Allocate assets

Do this according to your risk appetite and target growth rate. The former determines your instruments, the latter your exit point.

2. Consider the long-term

- Defining breakout and breakdown points is just one way to acquire a long-term perspective of the market. Sound investments always stand the test of time.
- Also remember that fear at the bottom is far higher than greed at the top of the market. But by regulating fear and greed, you can tide your way to handsome profits.

3. Reject lengthy lock-ins

The longer the lock-in, the more suspect the claim of the product. No one can sacrifice liquidity in a volatile market. If you find an instrument with zero lock-in, we urge you to study it alertly.

4. Avoid layered products

Management fee, carry, taxation and other costs must be ascertained at the earliest to estimate the true rate of return.

5. Nurse a healthy scepticism

Every financial product needs to be treated with suspect till one has had the opportunity to study it thoroughly. If it sounds too good to be true, it probably is. And if the product is rather innovative, be rather watchful.

6. Consider products with negligible commissions

Plain AAA rated government-backed tax-free bonds perform as good or better than most debt funds across time periods because debt funds are at the mercy of interest rates. Another reason to buy them: the commissions are negligible.

7. Conduct a physical audit

Conduct a physical audit of our client's portfolio as soon as we begin the relationship. This is to help ascertain and validate the the accuracy of the MIS being received from Wealth Managers.