

Wise Advice Case Competition 2017

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Case Summary:

Case Summary:

Mr. Mohan Kulkarni who is 63 years of age has retired from an MNC after 33 years of service. He has bought 3 BHK apartment for Rs.1.5 Crores before 3 years of retirement where he is living with his wife Mrs. Swati Kulkarni. Kulkarni's have one daughter, Ms. Varsha who has been recently divorced. Varsha has returned back to Mr. Kulkarni's place along with her 2 year old son Rohan. Currently she is staying with her parents in Pune. Mr. Kulkarni has investible corpus of Rs. 2 Crores, which has been invested as follows,

- 1 Crore in Fixed deposit earning 8% currently and will be renewed at 6.5% as informed by the bank
- 1 Crore in hybrid funds having an allocation of 25% in equity and 75% in debt respectively.

Mr. Kulkarni recently incurred huge expenses of 26 lakhs for his mother's illness as no one in the family was covered by comprehensive health insurance cover.

Mr. Kulkarni used to spend Rs. 75,000 per month for household expenses which have increased to Rs.1 Lakh per month after Swati and Rohan came back to stay with them.

The advisor needs to help Mr. Mohan Kulkarni and his family to achieve their financial goals by prudently investing the available corpus, mitigate the risks by suggesting right insurance and for estate planning.

Assumptions:

1. Monthly superannuation income from uncommuted portion is taxable as per tax bracket.
2. Property tax and maintenance for property is included in current expenditure
3. Mr. Kulkarni can sell his current 3 BHK property for Rs. 1.5 Crores post tax and expenses.
4. Mr. Kulkarni can take a rented accommodation at Rs. 16,600 per month.
5. Inflation is assumed at 4 % per annum.

Risk Tolerance:

1. Purchase of 3 BHK house for Rs. 1.50 Crores has significantly reduced Mr. Kulkarni's liquidity and income generating assets.
2. An unexpected expenditure of Rs. 26 Lakhs spent on Mr. Kulkarni's ailing mother has also reduced the corpus.
3. There are total three dependents in the family.
4. Current allocation of Rs. 25 Lakhs to equity out of total assets indicates low willingness to take risk.
5. Mr. Mohan has worked in the same company for 33 years indicates conservative approach.

All the above points highlight that Mr. Mohan has **below average risk tolerance.**

Goals:

Mr. Kulkarni has two time horizons and multiple goals. First time horizon is till Varsha settles down by securing a good job and second being till Mr. & Mrs. Kulkarni are alive.

Goal List:

1. Providing for monthly expenses post retirement and maintaining the real value of investment
2. Supporting Varsha till she settles down in her life
3. Providing for his Grandson's future as Varsha alone may not be able to accumulate enough funds
4. Plan investments for the annual travel
5. Provide for emergencies in the family
6. With age health expenses would go up and Mr. Kulkarni needs to provide funds for that
7. Do estate planning for transferring the wealth smoothly to next generation

Return Requirement:

| Monthly Expense Requirement | Amount in Rs. |
|---|----------------|
| For Mr. Mohan & His wife | 75,000 |
| For Varsha | 25,000 |
| For Travel (4L Per Annum) | 33,333 |
| Total Post Tax Monthly Requirement | 133,333 |
| Funds from Superannuation Plan | - 25,000 |
| Net Post Tax Monthly Requirement | 108,333 |

Apart from these expenses there will be additional cost for health insurance which should be provided for.

Rent required for 2 BHK accommodation assuming 2% rental yield and 1 Cr. Property Price is Rs.16,667

Following are five key scenarios and return requirement in each case.

| Net Corpus & Return Requirement | | | | | | |
|---------------------------------|--|------------------------------|----------------------------------|-----------------------------|-------------------|-----------------------------------|
| Scenario | Option | Net Income Generating Assets | Net Post Tax Monthly Requirement | Post Tax Return Requirement | Assumed Inflation | Total Return Requirement Post Tax |
| Scenario 1 | Sell current 3 BHK and Varsha stays with Father in rented apartment | 35,000,000 | 125,000 | 4.29% | 4% | 8.29% |
| Scenario 2 | Sell current 3 BHK and Buy Varsha 1 BHK | 29,000,000 | 125,000 | 5.17% | 4% | 9.17% |
| Scenario 3 | Continue Stay in 3 BHK and Varsha stays with Father | 20,000,000 | 108,333 | 6.50% | 4% | 10.50% |
| Scenario 4 | Continue Stay in 3 BHK and buy Varsha 1 BHK | 14,000,000 | 108,333 | 9.29% | 4% | 13.29% |
| Scenario 5 | Continue Stay in 3 BHK and Varsha stays with Father but delay Travel | 20,000,000 | 75,000 | 4.50% | 4% | 8.50% |

Taxation:

1. Case states that Mr. Kulkarni is in 20% tax bracket.
2. He earns 25,000 per month from superannuation which amounts to Rs. 3 Lakhs per annum
3. Rs. 1 Crore Fixed Deposit renewed at 6.5 % gives Rs. 6.5 Lakhs per annum.
4. Total income adds up to Rs. 9.5 Lakhs. Additional interest income will put him in 30% tax bracket, leaving lesser money for consumption as tax liability will increase.
5. Tax saving of Rs. 1.50 Lakhs u/s 80 C could help reduce the taxes. Health insurance premium paid will give deduction u/s 80 D.

Overall Mr. Kulkarni needs to reduce the tax burden by limiting investments in taxable instruments.

Capital Market Expectation:

Current Macro Scenario:

- Inflation is under control.
- Forex reserves are increasing at stable rate.
- Political System appears stable.
- Current account deficit and Fiscal deficit are declining.
- Central bank is neutral on policy stance.

The current micro scenario:

- Corporate growth has bottomed out.
- Lower interest rates are helping corporates to reduce interest burden.
- Capital expenditure is government driven.
- Consumer confidence is improving.
- 10 Year G-Sec is at 6.63 YTM.
- Credit spreads have narrowed down
- GST implementation will bring transparency as compliance will rise thus boosting government revenue from indirect taxes.

Current macro and micro scenario indicates an early stage upswing in the economy and stable interest rates going forward.

| Based on that the capital market assumption is | |
|--|------|
| Return on Debt | 7.5% |
| Return on Equity | 12% |

Behavioral Biases:

Kulkarni Family has many biases which are mostly emotional and hence can be dealt with by counselling.

First Bias Mrs. Swati has relates to her decision to stick with fixed deposit schemes. It is more of a novel investor psychology. It can be attributed to **Psychology of risk /home bias/availability bias** where investor invests only in known investments. It can also be attributed to **loss aversion bias** where she wants to have secured income without any variability.

The second bias relates to her decision to buy a one bedroom house for her child as she feels it will make her feel secure and independent. However in reality things may be different as there is a probability that Varsha won't feel independent or secured if she stays away from her parents in the one bedroom flat. After all Varsha's son, Rohan will have to be with his grandparents once she leaves for work. This bias is called **Hedonic Treadmill**. Hedonic Treadmill means that a person thinks he/she will feel happy after the occurrence of a certain event but it may not be the case.

Asset Allocation:

Based on return requirements, capital market assumptions; following are the 5 asset allocation scenario.

Scenario 5 is the most suitable scenario where Mr. and Mrs. Mohan Kulkarni decide to stay in 3 BHK property where he is living currently, Mr. and Mrs. Kulkarni delay their annual travel plan and Varsha and Rohan stay with them.

Based on return requirement and capital market expectation, the debt/equity allocation is as given below.

| Asset Allocation | | | |
|------------------|--------|--------|-----------------------------------|
| | Debt | Equity | Total Return Requirement Post Tax |
| Scenario 1 | 82.5% | 17.5% | 8.29% |
| Scenario 2 | 62.8% | 37.2% | 9.17% |
| Scenario 3 | 33.3% | 66.7% | 10.50% |
| Scenario 4 | -28.6% | 128.6% | 13.29% |
| Scenario 5 | 77.8% | 22.2% | 8.50% |

In Scenario 1 and 2, Mr. Kulkarni is supposed to sell his 3 BHK and stay in a rented apartment. Emotionally it would be difficult for them to take this decision and may not go with the same.

In Scenario 3 and 4, Mr. Kulkarni keeps his 3 BHK, but the asset allocation is skewed towards equity. Scenario 4 suggests that Mr. Kulkarni should borrow and invest in equity. Looking at the current life stage and risk tolerance Mr. Kulkarni may not be able to select scenario 3 and 4. And it will be extremely difficult to get loans at this age.

Clearly looking at Mr. Kulkarni's below average risk tolerance, he needs to go with scenario 5 where equity allocation is 22.2% of total assets.

Scenario 5: Mr. and Mrs. Kulkarni stay in 3 BHK, delay their annual travel plan and Varsha and Rohan stay with them.

The asset allocation in scenario 5 is 22.2% in the favour of equity which is still on the higher side compared to Mr. Kulkarni's risk tolerance but he gets to keep the house but only delays his travel plan by a couple of years. To adapt with Kulkarni family's behavioral biases we can adjust the equity allocation downward to 25-30%.

Any additional income generated or extra savings can be reinvested in current corpus to grow it. When Varsha becomes independent, Mr. Kulkarni and Mrs. Kulkarni can start planning for their travel goals as expenses will be reduced considerably.

Once Varsha starts working, she should immediately start investing in a systematic manner to plan her retirement, Rohan's education and marriage. For these long term goals she can start Systematic Investment Plans in equity mutual funds.

Product Allocation:

| | | |
|-------------------|-----------------------------------|-------------------|
| Scenario 5 | Investible Corpus in Rs. | 20,000,000 |
| | Monthly Requirement in Rs. | 75,000 |

Mr. Kulkarni stays in 3 BHK house, delays his annual travel plan and Varsha stays with him.

The additional funds generated monthly should be used for paying health insurance premium. Our estimate for Mr. & Mrs. Kulkarni and Varsha and her Son is close to 85,000 per year assuming Mr. and Mrs. Kulkarni opt for Rs. 10 lakhs cover each and Varsha buys family floater of Rs. 10 lakhs covering herself and Rohan.

| Investment Type | Product | Amount | Allocation % | Monthly Income Amount | Comment |
|-----------------|-------------------------------|-------------------|--------------|-----------------------|--|
| Emergency Fund | Liquid Fund | 500,000 | 3% | | Total 6-7 Months expenses are kept in liquid fund for any emergency needs. |
| Monthly Income | Short Term/ Accrual Debt Fund | 15,000,000 | 75% | 93,750 | SWP in Short term debt funds will serve for monthly income needed and taxation will be lower than FD. |
| Equity | Large Cap | 3,000,000 | 15% | | As Mr. Kulkarni is conservative, the equity allocation needs to be biased towards large cap funds. As market has rallied recently, the investment should be executed systematically through STP. |
| Equity | Diversified | 1,500,000 | 8% | | |
| Equity | Mid and small Cap | NIL | 0% | | |
| | Total | 20,000,000 | 100% | 93,750 | |

Insurance

- Mr. & Mrs. Kulkarni must get comprehensive health insurance cover. Mr. Mohan Kulkarni has incurred huge amount of Rs. 26 lakhs out of his own pocket to treat his ailing mother. Healthcare inflation in India are in the region of 15% per annum and the risk today is living longer. Therefore buying a health insurance should be treated as a priority item.
- Varsha and her son Rohan should also buy purchase health insurance cover immediately. Mr. Kulkarni can provide for the cost of health insurance till Varsha gets settled.
- Once Varsha starts working she should immediately get term insurance and personal accident insurance as Rohan is financially dependent on her.

Estate Planning:

'When there is a WILL; there is a way.' Mr. Mohan Kulkarni must start with preparing the will on a priority basis. He can put his daughter's name as beneficiary for his house and other assets. This will take care of Mrs. Kulkarni's need regarding buying house for Varsha as she is beneficiary in current house.

Conclusion:

Mr. Kulkarni has accumulated large corpus till retirement but because of unexpected circumstances that corpus appears insufficient to meet his regular expenses and family's travel plans.

This looks a like a short phase of life where his daughter Varsha and grandson Rohan are dependent on him.

He has to plan the asset allocation as per these needs.

Advisors main job is to consult Mr. Kulkarni and direct him to take these investment decisions. Advisor has to adapt to Kulkarni family's emotional biases.