

Manage your returns expectations

VOLATILE TIMES

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Given the turbulent investing environment over the past several years and the volatility even in asset classes such as debt that were earlier seen as safe instruments, many investors are confused. In investing, as in most things in life, it is useful at times like these to calibrate your expectations. It's important to assess how much capital—that you have available for investment—is truly risk capital. To assess this ask yourself whether you are willing to lose this money? It is human nature to want higher returns associated with risk capital, but not many are willing to absorb the related losses, even if only for a temporary period. For example, while equity markets have yielded approximately 15% total returns since 1991, close to 11% of the times you would have made negative returns over a rolling five-year period. Moreover, there have been instances where the peak loss, has exceeded 50%. Faced with such a loss, will you be able to stay the course, or like many others will not be able to deal with the psychological pain and sell, usually at the worst possible time? Some studies suggest that losses are twice as powerful, psychologically, as gains.

Correspondingly, investing exclusively in safe, principal-protected securities are unlikely to yield post-tax, post-fee returns that keep up with inflation, much less compound your savings. After all, there is no free lunch. Recent events related to commodity arbitrage opportunities on the National Spot Exchange Ltd (NSEL) are a good reminder of this basic tenet. But more on this later.

In evaluating investment opportunities, a common mistake is to focus principally upon the expected return, without considering whether the post-fee, post-tax return is commensurate with the underlying risk. To take a somewhat obvious example, lending to a particular real estate developer at 30% would seem to be more attractive than lending to another at 22%. However, someone willing to pay a substantially higher rate is likely to be in a far more distressed circumstance, substantially increasing the probability of default. Sometimes, one has to be careful of what one wishes for.

The upside of an investment is usually well articulated by the seller or broker. However, it is incumbent on you, the investor, to think through what could go wrong. You may not have the answers, but you can certainly ask the questions. If you don't get straight answers, it's usually a warning sign. There are few, if any, "sure things" that should be made blindly without sufficient explanation.

As I stated previously, to generate returns one needs to take risks. Think how you can mitigate the risks. For example, investing in a real estate-backed non-convertible debenture or NCD may appear to be an attractive way to boost debt returns, but in case of a delay or default in repayment, what are your options? Although the NCD may be secured, are you equipped to go through the various procedural and legal steps to take control of the assets and recover your dues?

Real estate is inherently a high-risk asset class and developers in distress will most likely default first on loans from individuals. However, they will think long and hard before defaulting on loans from institutions that they perceive to be ongoing sources of capital and which have the wherewithal to fully exercise contractual rights and realize value from the underlying collateral securing the loan. Accordingly, can you co-invest with institutional capital, ideally at the same time and on the same terms, and where the institution has agreed to

hold a significant percentage of the deal through maturity? This ensures that your interests are aligned and maximizes the chances of recovery should a loan go sour.

The NSEL case is a good encapsulation of many of the points I have laid out. Brokers implied, or even stated explicitly, that commodity arbitrage was a risk-less way to earn about 200 basis points more than the prevailing returns from liquid funds. With equity markets under pressure, for many investors it was a very appealing proposition. However, if one had asked questions, one could have identified many of the issues that have now come to light. Questions could have been asked around issues such as counter-party risk and inadequacy of the settlement guarantee fund. In fact, there were investors who did ask these questions and not comfortable with the responses decided not to invest. The point was not that they knew definitively that there would be a problem, just that the risks existed and that the expected returns did not justify taking such risks.

Remember: if it is too good to be true, it usually is.

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