

FINANCIAL JARGONS TO KNOW

It's likely your adviser will fall back on using this jargon when soliciting your business and, later, in the planning and execution of your financial accounts. In some cases, the words may sound impressive; in other cases, intimidating or confusing. Worse, some of the vocabulary isn't what it sounds like..

Bottom Up Investing - This investing strategy is a good example of figurative speech that implies one thing but is actually something very different. This phrase does not mean buying assets at the bottom of their price range or the cheapest stocks available. Instead, it's an investing approach based on focusing on a specific company rather than its industry, the economy or market cycles. Apple arguably falls into this category because its business has performed far better than rivals and the overall U.S. economy

Law Of Large Numbers - If you're unhappy with your adviser's performance, and you complain, you might hear about this theory.

Simply put, it posits that beating large numbers — say, large numbers of investors (or other fund managers) — is very difficult to achieve. Put another way, it's rare that your adviser will outperform the general market.



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Inflation Indexed Bonds: An Alternative To Gold?

The RBI has issued inflation-indexed bonds (IIBs) to cushion your savings against rising prices. These financial instruments are meant to encourage savings and wean investors away from gold. This might help the government reduce the import bill for gold to an extent. Thus, leading to reduction in India's Current Account Deficit (CAD).

Why Do We Need IIBs?

Inflation erodes the purchasing power of money. Most debt products such as fixed deposits (FDs) or regular bonds provide returns that are not protected against inflation. If a bank FD pays an interest rate of 9% per annum and inflation averages 9.5% that year, the investor loses money in real terms.

This is because the real rate of return of the FD in this case would be -0.46%. This is where IIBs come handy. These bonds adjust the principal investment to the inflation so that the investor earns a higher interest.

Example:

If you pay Rs. 100 for a bond that tells you it will pay 7% a year, the normal expectation is to get Rs. 7 per year, because the 7% ("coupon") is on the Rs. 100 ("principal"). But, in case you invest in IIBs this is how it works.

Year 1: Let's say inflation is 10%. That means the WPI index, which was 200 at start, is now 220. The calculation is that principal goes up by this amount and so does interest.

So, principal = issue time principal * (current WPI / WPI index at issue time). Or, principal = $100 * (220/200) = 110$.

The New Principal is Rs. 110. Interest paid out = $Rs. 110 * 7%$ (constant coupon). = Rs. 7.7.

Year 2: Let's say inflation is 5%. So the WPI is at $(220 * 105%) = 231$.

Same calculations give us: New Principal = $100 * (231/200) = Rs. 115.5$

Interest paid out = 7% of 115.5 = Rs. 8.085

And so on. But, if you invested in a regular bond you would get only Rs 7 every year.

Disadvantages

Although inflation-indexed bonds prove beneficial during times of high inflation, they underperform when the economy goes through a deflationary phase and prices actually come down. In such a situation, the IIB will give lower than the coupon rate because the principal would get adjusted below Rs 1,000. However, this is only a theoretical risk. A decline in wholesale prices is not even a remote possibility in India.

Another drawback of these bonds is that they have been indexed to the WPI and not the Consumer Price Index (CPI). For most investors in bonds, the CPI is the more relevant index. Consumer prices matter to them in day-to-day life than wholesale prices. Currently, while WPI has declined below 5%, CPI continues to be in double digits.

Conclusion

While they were launched with the aim to target investors who use gold as an investment to hedge against inflation, it will be difficult for them to completely replace gold as investors buy gold for consumption. This need cannot be substituted.

On the other hand, informed investors who use gold to hedge against inflation and are buying gold exchange-traded funds or bars/coins can perhaps replace gold with these bonds.

Disintermediation It has been practiced in recent years because of the global financial crisis. It is the movement of savings or investment funds away from institutions such as banks into higher-yielding investments in the securities markets, such as Treasuries.

Efficient Frontier -If your adviser mentions "efficient frontier," it's a reference to the concept that different groups of securities have different elements of risk and return on investment — and that there is an optimal meeting point on a parabolic chart. Presumably, then, there is such a point for you and your investments.

Guaranteed Income Contract - In particular, with a GIC, the contract calls for an insurance company to borrow a lump sum from you at a pre-determined interest rate that then produces a pre-determined amount of cash at a specified future date.

What are Derivatives?



Derivatives were created to help banks, investors and corporations, to manage risk. Derivatives are:

Financial arrangements between two groups payment's to one of these parties are made based off of the performance of an agreed upon price move of an item. These items can include: Commodities, Corporate Bonds, Currency, Government Debt, Interest Rates, Mortgages, Stocks, etc.

Simple Example: Let's say we go out and I buy you a cup of coffee for \$1.00. We agree that the next time we meet, you will return the favor. We sign contracts and everything.

This is in essence a derivative contract. I bought a future cup of coffee today for a dollar and you agreed to give it to me at any time in the future. If we don't see each other for five years, or the price of coffee sky-rockets, I will make out quite well! If however, coffee is available out of a tap for next to nothing, I lost my dollar.

Derivatives are just a bet that something will be worth more or less at some point in the future.

The only difference between my coffee example and real derivatives is complexity. There are thousands of different kinds of derivatives that are managed, for the most part, by computers because of their complexity.

There are Different Types of Derivatives

There are two basic types of derivatives, option contracts and forward contracts. These can either be traded on an exchange, or privately.

An option gives the buyer the right, but not the obligation, to buy or sell something at a predefined price, until a specific date. This option normally costs a fraction of the cost of the asset.

A forward contract (Future / Swap) forces the buyer and seller to make a trade on a specific date in the future, and at a set price.

Why are they needed?

They take a lot of risk out of doing business, by spreading that risk to many other people, for a fee. Businesses would be very unstable if they weren't allowed to stabilize their raw material and currency risks.

Look at South West Airlines as an example. South West, during the period when gas cost \$4 a gallon, saw their profits sore because they had established derivative's that allowed them to buy fuel for \$50 a barrel.

Without those derivatives they would have been in the same shape as many other airlines. That definitely would have cost them a loss in profits, but also a loss in jobs.

Derivatives exist for one reason. They are the cheapest way for a company to protect themselves from normally unforeseen risks.

Why are they Dangerous?

You have probably heard the word leverage? Leverage can multiply losses or gains quite substantially. Remember, when you enter into a derivative agreement, you pay a fraction of what the asset costs.

Also, the asset is normally purchased and then sold to the counter party at nearly the same time. Let's use South West as an example again:

They bought the option to purchase barrels of fuel at \$50 when those same barrels were worth about \$35. Sounds stupid right? Wrong!

They paid a \$1 or \$2, per barrel for that option

All this while, the counter party didn't buy the barrels and store them for \$35 a piece. (Oil Rots if kept for a long time)

On June 2008, oil now costs \$125 a barrel.

South West's counter party is now on the hook for buying those barrels of oil for \$125 and then selling them for only \$50 (\$75 Loss per barrel for a measly couple bucks)

South West got a return of 37.5 times, not percent!

Their counter party lost 37.5 times more!!!

That's leverage! The chance that you can lose considerably more than you ever invested, or made from the original investment.