

## **Unit 4 – Financial Planning & Scheme Selection**

### **1. Financial Planning Steps**

Financial planning involves creating a roadmap to manage your finances and achieve your personal goals. Here are the key steps to effective financial planning:

#### **1. Set Clear Financial Goals**

- Define short-term (1-2 years), medium-term (3-5 years), and long-term (5+ years) financial goals. These could include building an emergency fund, buying a house, saving for retirement, etc.

#### **2. Assess Your Current Financial Situation**

- Review your income, expenses, savings, debt, and investments to get a clear picture of your financial health.
- Use tools like budgeting apps or spreadsheets to track your cash flow.

#### **3. Create a Budget**

- Plan a realistic budget based on your income and expenses. Prioritize essential expenses, savings, and debt repayments.
- The 50/30/20 rule can be a helpful guide: 50% of income for needs, 30% for wants, and 20% for savings and debt repayment.

#### **4. Build an Emergency Fund**

- Set aside 3-6 months' worth of living expenses in a liquid savings account to cover unexpected events like medical emergencies or job loss.

#### **5. Manage Debt**

- Develop a strategy to pay off high-interest debt (e.g., credit card debt, personal loans) as quickly as possible.
- Consider consolidating or refinancing debt if it reduces your interest rates or payments.

#### **6. Save and Invest for the Future**

- Begin saving early for medium and long-term goals such as buying a home, funding education, or retiring.
- Invest in a diversified portfolio of assets (stocks, bonds, real estate, etc.) according to your risk tolerance and time horizon.
- Contribute to retirement accounts like 401(k)s, IRAs, or other tax-advantaged savings plans.

#### **7. Protect Your Assets**

- Ensure you have adequate insurance coverage (health, life, disability, auto, home) to protect yourself and your family.

- Consider estate planning (wills, trusts) to protect your wealth and ensure it is passed on according to your wishes.

## 8. Monitor and Adjust Your Plan

- Regularly review your financial plan, adjust for life changes (marriage, children, new job), and make improvements to keep it aligned with your goals.
- Update your investments, budget, and insurance policies as needed.

## 9. Plan for Taxes

- Understand your tax liabilities and look for ways to minimize them, such as contributing to tax-deferred accounts or taking advantage of deductions and credits.
- Consider working with a tax professional to optimize your tax strategy.

## 10. Seek Professional Advice

- If your financial situation becomes complex, consider consulting a certified financial planner (CFP) for tailored advice.

## 2. Financial Lifecycle

The **Financial Life Cycle** refers to the stages individuals typically go through in managing their finances over their lifetime. Each stage involves different financial goals, challenges, and strategies.

### Stages of the Financial Life Cycle

#### 1. Early Career Stage (20s to early 30s)

- **Characteristics:**
  - Individuals are often just starting their careers, experiencing lower income levels, and potentially managing student loans.
  - This stage is characterized by significant lifestyle changes, such as moving out on one's own, starting a job, or possibly starting a family.
- **Financial Goals:**
  - **Establishing a Budget:** Understanding income and expenses and starting to save.
  - **Building an Emergency Fund:** Saving enough to cover 3-6 months of living expenses for unforeseen circumstances.
  - **Managing Debt:** Paying off high-interest debts like credit cards and possibly student loans.
  - **Starting Retirement Savings:** Contributing to retirement accounts like a 401(k) or IRA, taking advantage of employer matching programs if available.
- **Strategies:**
  - Focus on debt reduction and building savings.
  - Start investing early to take advantage of compound interest.
  - Live within or below your means to avoid accumulating unnecessary debt.

#### 2. Mid-Career Stage (30s to 40s)

- **Characteristics:**
    - Individuals may see an increase in income due to career advancements.
    - Life changes such as marriage, buying a home, or having children often occur during this stage, impacting financial priorities.
  - **Financial Goals:**
    - **Increasing Savings and Investments:** Boosting retirement savings and investing in growth-oriented assets.
    - **Homeownership:** Saving for a down payment or managing a mortgage.
    - **Planning for Children's Education:** Starting a college fund or 529 plan.
    - **Insurance Coverage:** Ensuring adequate health, life, and disability insurance to protect the family.
  - **Strategies:**
    - Continue to prioritize retirement savings and consider a diversified investment strategy.
    - Manage debt wisely, ensuring that mortgage payments and other debts do not overwhelm the budget.
    - Reevaluate and adjust financial plans regularly to reflect changes in income, family size, and life goals.
3. **Pre-Retirement Stage (50s to early 60s)**
- **Characteristics:**
    - Individuals are typically at their peak earning potential but may also face high expenses, such as children's college tuition or caring for aging parents.
    - There is a greater focus on solidifying retirement plans and reducing financial risk.
  - **Financial Goals:**
    - **Maximizing Retirement Contributions:** Taking advantage of catch-up contributions to retirement accounts.
    - **Debt Reduction:** Paying off mortgages and other debts to reduce expenses in retirement.
    - **Retirement Planning:** Estimating retirement needs and developing a strategy for withdrawing funds.
    - **Health Care Planning:** Considering long-term care insurance and understanding healthcare needs and costs.
  - **Strategies:**
    - Shift investments gradually toward lower-risk options to preserve capital while still achieving growth.
    - Create or refine a retirement income plan that includes Social Security, pensions, and retirement savings.
    - Focus on building a diversified portfolio that balances growth with stability.
4. **Retirement Stage (Mid-60s and Beyond)**
- **Characteristics:**
    - Income typically comes from retirement accounts, Social Security, pensions, and possibly part-time work or investments.
    - The focus shifts to preserving wealth, generating income, and ensuring that savings last through retirement.
  - **Financial Goals:**

- **Income Management:** Ensuring a steady income stream from retirement savings, investments, and Social Security.
- **Minimizing Taxes:** Strategically withdrawing from retirement accounts to minimize tax burdens.
- **Estate Planning:** Creating or updating a will, setting up trusts, and planning for the distribution of assets.
- **Health Care Costs:** Managing increasing healthcare costs and considering options like Medicare and supplemental insurance.
- **Strategies:**
  - Opt for more conservative investments to protect capital and provide income.
  - Monitor spending carefully to ensure funds last throughout retirement.
  - Review and adjust financial plans regularly to account for changes in health, life expectancy, and economic conditions.

### 3. Wealth cycle

The **wealth life cycle** refers to the stages individuals typically go through in building, maintaining, and spending wealth throughout their lives. It is often broken down into three primary phases:

#### 1. Accumulation Phase (Young Adulthood to Midlife)

- **Focus:** Earning and saving.
- **Income:** Typically growing as individuals advance in their careers.
- **Behavior:** Investing in education, buying a home, building a career, and saving for the future. Investment strategies during this stage are often more aggressive, as individuals have time to recover from market downturns.
- **Risk Tolerance:** Higher, as there's more time to rebuild lost wealth.

#### 2. Consolidation or Preservation Phase (Midlife to Pre-Retirement)

- **Focus:** Growing and protecting wealth.
- **Income:** Reaches its peak and then begins to stabilize or slightly decline.
- **Behavior:** Individuals may prioritize paying off debts, preparing for retirement, and protecting their wealth with safer investments. They start shifting toward less risky investments to preserve what they've built.
- **Risk Tolerance:** Moderate, as wealth preservation becomes a key concern.

#### 3. Distribution or Spending Phase (Retirement)

- **Focus:** Using wealth to maintain lifestyle during retirement.
- **Income:** May come from savings, pensions, or investment returns rather than employment.
- **Behavior:** Individuals focus on managing withdrawals, ensuring they don't outlive their savings. This phase emphasizes financial stability and liquidity.
- **Risk Tolerance:** Lower, with a focus on secure, income-generating investments.

## 4. Risk Profiling

**Risk profiling** is a critical process used to evaluate an individual's or an institution's risk tolerance, risk capacity, and risk requirement, which helps in formulating investment strategies that align with their financial goals and comfort levels. It serves as a foundation for creating a portfolio that balances risk and return based on an investor's characteristics.

### Key Components of Risk Profiling

#### 1. Risk Tolerance

- **Definition:** The emotional ability to withstand market volatility or financial losses.
- **Measurement:** Typically assessed through behavioral questionnaires that gauge responses to different market conditions, such as how comfortable a person feels when investments lose value or how much risk they are willing to take for the possibility of higher returns.
- **Factors:**
  - Personal psychology and past experiences with financial loss.
  - Willingness to accept short-term volatility for potential long-term gains.
  - Reaction to financial downturns (e.g., selling in panic or holding steady).

#### 2. Risk Capacity

- **Definition:** The objective financial ability to take on risk based on the person's financial position, such as income, savings, age, and liabilities.
- **Factors:**
  - **Income:** Higher and more stable income increases risk capacity.
  - **Savings and assets:** Larger savings and diversified assets allow for greater risk-taking.
  - **Time horizon:** A longer investment horizon increases risk capacity because there's more time to recover from market downturns.
  - **Expenses and liabilities:** High fixed expenses or significant liabilities (e.g., mortgages, children's education costs) can reduce risk capacity.

#### 3. Risk Requirement

- **Definition:** The level of risk needed to meet financial goals within a given time frame.
- **Example:** An investor may need a certain rate of return to meet retirement goals. This may necessitate taking on more risk than they are emotionally comfortable with, or adjusting their goals or savings rate to align with their risk profile.

### Types of Risk Profiles

Based on risk tolerance, capacity, and requirement, investors can generally be classified into the following risk profiles:

#### 1. Very Conservative (Low Risk Tolerance and Capacity)

- Prefers preserving capital with minimal to no risk.
- Suitable for those near retirement or with short-term financial goals.

- Focus on safe, low-volatility investments like government bonds, savings accounts, or money market funds.
- 2. **Conservative (Low Risk Tolerance, Moderate Risk Capacity)**
  - Seeks steady income and capital protection, with some willingness to accept slight volatility for modest growth.
  - Typically invested in fixed-income securities like bonds and a small portion of equities.
- 3. **Moderate (Balanced Tolerance and Capacity)**
  - Aims for a mix of growth and income, accepting moderate risk.
  - A balanced portfolio often consisting of 50-60% equities and 40-50% bonds or fixed-income securities.
- 4. **Growth (High Risk Tolerance, High Capacity)**
  - Focuses on capital appreciation and is willing to accept higher short-term volatility for long-term gains.
  - Suitable for investors with a longer time horizon, investing heavily in equities and growth-focused funds.
- 5. **Aggressive (High Risk Tolerance, Very High Capacity)**
  - Primarily seeks high returns and is comfortable with substantial volatility and potential losses.
  - Predominantly invests in equities, alternative investments (e.g., private equity, venture capital), and other high-risk, high-return assets.

### **Risk Profiling Process**

1. **Questionnaire and Assessment:** Investors usually complete a risk profiling questionnaire that includes questions about their financial situation, time horizon, investment goals, and emotional response to risk.
2. **Analysis:** Financial advisors analyze the responses to understand how much risk the investor can and should take. This analysis helps create a customized investment strategy.
3. **Portfolio Construction:** Based on the investor's risk profile, a tailored portfolio is constructed. For instance:
  - A conservative profile may focus on income-generating and low-volatility assets.
  - An aggressive profile will have more exposure to high-growth, high-volatility assets.
4. **Ongoing Review:** Risk profiling is not static. As an investor's financial situation or goals change, the risk profile may need to be reassessed and the portfolio adjusted accordingly.

### **5. Contingency Funds**

Contingency funds, also known as emergency funds or reserve funds, are savings set aside to cover unexpected expenses or financial emergencies. These funds serve as a financial safety net, protecting individuals, households, or businesses from the risks of unforeseen costs or income disruptions.

### **Key Features of Contingency Funds**

1. **Liquidity:**
  - Contingency funds need to be highly liquid, meaning they should be easily accessible without penalties or delays. Typically, they are stored in savings accounts, money market funds, or short-term deposits.
2. **Safety:**
  - Safety is a key priority for contingency funds, so they are typically invested in low-risk instruments. The primary goal is to preserve the capital rather than earn high returns.
3. **Adequate Size:**
  - Financial experts typically recommend setting aside enough to cover **3 to 6 months** of essential living expenses. For businesses, this amount may be larger, depending on fixed costs and potential risks.
  - The exact size will depend on various factors:
    - **Job stability:** If income is unpredictable, you may need a larger fund.
    - **Dependents:** A family with children will likely need a larger reserve than an individual.
    - **Health:** Those with ongoing medical conditions or without health insurance may need more substantial reserves.
    - **Debt:** People with high debt obligations may need to set aside more funds to manage payments in case of a job loss.
4. **Separate from Other Savings:**
  - A contingency fund should be kept separate from long-term savings, like retirement or investment accounts. This distinction helps ensure the fund is only used for emergencies.

## Types of Contingency Funds

1. **Personal Contingency Fund:**
  - Individuals and households create these funds to manage unexpected personal financial emergencies like job loss, medical expenses, or urgent home repairs.
2. **Business Contingency Fund:**
  - Businesses maintain contingency funds to address cash flow shortages, unexpected expenses, or market downturns. These funds are vital for maintaining operations during difficult periods without the need to borrow.
3. **Government or National Contingency Fund:**
  - Governments set aside funds to deal with national emergencies, natural disasters, or financial crises. This helps the government provide relief or stimulus packages during difficult times.

## 6. Eligibility for Investment in Mutual Funds

To be eligible to invest in mutual funds, you generally need to meet the following criteria:

### 1. Age Requirement:

- **Minimum Age:** In most countries, you must be at least 18 years old to invest in mutual funds. Minors can invest through a guardian or parent.

### 2. Residency and Nationality:

- You typically need to be a resident or citizen of the country where the mutual fund is offered. Some mutual funds may allow non-resident or foreign investors, but restrictions may apply.

### **3. Identification:**

- Investors need valid identification documents such as a passport, national ID card, or driver's license.

### **4. Bank Account:**

- A bank account is usually required for fund transactions, including buying, selling, and receiving dividends.

### **5. Minimum Investment Amount:**

- Mutual funds often have minimum investment requirements, which can vary widely. Some funds allow small initial investments, while others may require more substantial amounts.

### **6. KYC (Know Your Customer) Compliance:**

- Many countries require mutual fund investors to complete KYC formalities. This typically involves submitting personal and financial information for regulatory compliance and fraud prevention.

### **7. Risk Awareness and Suitability:**

- Some mutual funds, particularly higher-risk funds, may have suitability criteria. Fund managers may assess your financial profile and risk tolerance to ensure the investment is appropriate for you.

### **8. Accreditation (for Specific Funds):**

- In certain cases, especially for private or institutional mutual funds, you may need to be an accredited investor. This usually means meeting specific income or net worth thresholds.

### **7. KYC in Mutual Funds**

The KYC process in mutual funds generally involves the following steps:

#### **1. Fill Out the KYC Form:**

- Investors need to fill out the KYC application form, which is available on the websites of fund houses, registrars (like CAMS or KFintech), or at physical branches.

#### **2. Submit Required Documents:**

- Investors must submit documents for **identity proof** and **address proof**, such as:
  - **Identity Proof:** PAN Card, Aadhaar, Passport, Voter ID, etc.

- **Address Proof:** Utility bills, Aadhaar, Passport, Driving License, etc.
3. **In-Person Verification (IPV):**
    - Some jurisdictions or funds require **In-Person Verification (IPV)**, where the investor's identity is verified in person. However, in many places, this can now be done digitally through video KYC or Aadhaar-based eKYC, making the process much faster.
  4. **KYC Registration:**
    - Once the KYC documents are submitted, the mutual fund house sends them to a KYC Registration Agency (KRA), which maintains a central KYC database. Once approved, the investor receives a KYC compliance confirmation.
  5. **KYC Status Check:**
    - After submitting the required documents, investors can check their KYC status through the KRA's website or mutual fund service provider. Once completed, they can start investing in any mutual fund without repeating the KYC process.

### Types of KYC:

1. **Aadhaar-based eKYC (Electronic KYC):**
  - With Aadhaar, investors can complete the KYC process electronically. However, this has investment limits. For example, SEBI regulations allow only ₹50,000 per mutual fund in a year through eKYC.
2. **Full KYC:**
  - This is required when investors want to invest more than ₹50,000 per year. Full KYC involves submitting physical documents or completing video-based KYC to meet the regulations.
3. **Central KYC (CKYC):**
  - CKYC allows investors to complete their KYC once and use it across various financial services like mutual funds, insurance, and banking, simplifying the process for multiple investments.

### 8. Distinguish between Financial Advisors and Distributors

| Feature                        | Financial Advisor   | Mutual Fund Distributor  |
|--------------------------------|---|--|
| <b>Role</b>                    | Provides comprehensive financial planning and investment advice based on client goals, risk tolerance, and financial situation. | Primarily sells mutual fund products to clients and earns commissions.                               |
| <b>Services Provided</b>       | Holistic financial advice, including tax planning, estate planning, retirement planning, and investment strategies.             | Focuses mainly on recommending and facilitating mutual fund investments.                             |
| <b>Client-Centric Approach</b> | Fiduciary duty to act in the best interest of the client, offering unbiased advice.   | Generally aims to sell mutual fund schemes, which may involve a sales-driven approach.               |
| <b>Regulation</b>              | Typically registered with regulatory bodies (like SEBI in India) as <b>Registered Investment Advisors</b>                       | Registered with AMFI (Association of Mutual Funds in India) as a distributor. Not required to follow |

| <b>Feature</b>                         | <b>Financial Advisor</b>   | <b>Mutual Fund Distributor</b>   |
|--|--|--|
|  | ( <b>RIA</b> ) and must adhere to fiduciary standards.   | fiduciary standards but must follow AMFI's code of conduct.  |
| <b>Fee Structure</b>                   | Charges a <b>fee-based</b> model (either fixed, hourly, or as a percentage of assets under management). There are no hidden commissions. | Operates under a <b>commission-based</b> model, earning commissions from mutual fund companies for the sale of their products. |
| <b>Conflict of Interest</b>            | Low risk of conflict, as their compensation is fee-based and independent of product sales.   | Higher potential for conflict of interest, as income is tied to selling specific mutual fund schemes that offer commissions.   |
| <b>Scope of Advice</b>                 | Offers broad, personalized advice across various financial products, not limited to mutual funds.  | Primarily focuses on mutual fund schemes, with limited advice outside of that.   |
| <b>Suitability of Products</b>         | Recommends products that are best suited to the client's individual needs and financial goals.   | May recommend products that generate higher commissions, not necessarily what's best for the client.                           |
| <b>Client Relationship</b>             | Builds long-term relationships based on ongoing financial advice and monitoring.   | Relationship may be transactional, focusing on fund selection and execution of purchases.                                      |
| <b>Qualification and Certification</b> | Must hold certain qualifications such as CFP (Certified Financial Planner) or RIA certification.   | Must pass the NISM (National Institute of Securities Markets) certification exam to become an AMFI-registered distributor.     |
| <b>Product Range</b>                   | Advises on a wide range of financial products such as stocks, bonds, insurance, retirement plans, etc.                                   | Limited to mutual fund products. May not have expertise in other financial instruments.  |

## 9. Colour Coding Mutual Funds

**Colour coding of mutual funds** is a system implemented by the **Securities and Exchange Board of India (SEBI)** to help investors easily understand the level of risk associated with different mutual fund schemes. It uses three colours to indicate different risk levels, making it easier for investors to match their risk tolerance with the appropriate mutual funds.

### Colour Codes and Their Meanings:

| <b>Colour</b> | <b>Risk Level</b> | <b>Description</b>   | <b>Types of Funds</b>  |
|---------------|-------------------|--|--|
| <b>Blue</b>   | <b>Low Risk</b>   | Mutual fund schemes that invest primarily in low-risk, debt securities and government bonds. Suitable for conservative investors looking for capital preservation and stable income. | Debt funds (like liquid funds, ultra-short duration funds, etc.), government bond funds. |

| Colour | Risk Level    | Description   | Types of Funds  |
|--------|---------------|---|---|
| Yellow | Moderate Risk | Funds that carry a moderate level of risk. These schemes usually invest in a mix of debt and equity instruments, suitable for investors with a moderate risk appetite looking for balanced growth.          | Hybrid funds, balanced funds, certain debt-oriented hybrid funds.                                       |
| Brown  | High Risk     | Mutual fund schemes that invest primarily in equities or high-risk debt instruments. These funds are suitable for investors with a higher risk tolerance who are seeking higher returns over the long term. | Equity funds (large-cap, mid-cap, small-cap funds), sectoral/thematic funds, and high-yield debt funds. |

### How Investors Use Colour Coding:

- **Conservative Investors:** They may prefer mutual funds coded **blue**, indicating low risk. These investors prioritize capital preservation and steady, though smaller, returns.
- **Moderate Risk Investors:** Investors with a moderate appetite for risk may look for funds coded **yellow**, which offer a balance of growth and income with some exposure to equities but with lesser volatility than pure equity funds.
- **Aggressive Investors:** Investors seeking long-term capital appreciation and who can tolerate higher levels of market volatility will likely choose funds coded **brown**, indicating high risk and potentially high returns.

### 10. Bank FD Vs Mutual Funds

| Feature           | Bank Fixed Deposits (FDs)   | Mutual Funds   |
|-------------------|---|--|
| <b>Definition</b> | A financial product offered by banks where you deposit a lump sum amount for a fixed tenure at a predetermined interest rate.               | A pool of money collected from investors to invest in various securities like stocks, bonds, and money market instruments, managed by professionals.                       |
| <b>Returns</b>    | Fixed and guaranteed returns throughout the tenure. Interest rates are usually in the range of 3%–7% per annum (varies by bank and tenure). | Returns are market-linked and depend on the performance of underlying assets like equities or bonds. No guaranteed returns.  |
| <b>Risk</b>       | Virtually no risk, as FDs are considered one of the safest investment options.  | Risk varies based on the type of mutual fund (equity funds are high-risk, debt funds are lower risk).  |
| <b>Liquidity</b>  | Low liquidity. Premature withdrawal is allowed but comes with a penalty.  | High liquidity for most open-ended mutual funds. Investors can redeem units at the prevailing Net Asset Value (NAV) without penalty (except for exit loads in some cases). |
| <b>Safety</b>     | Highly safe, especially for deposits up to ₹5 lakh, which are insured by the  | Mutual funds are subject to market risks. No guarantee of safety, but lower-risk   |

|                                  |   |   |
|----------------------------------|---|---|
|                                  | Deposit Insurance and Credit Guarantee Corporation (DICGC).   | mutual funds (e.g., debt or liquid funds) are considered safer than equity funds.   |
| <b>Taxation on Returns</b>       | Interest earned is fully taxable as per the investor's income tax slab. No tax benefits on the interest income. | Taxed based on type of mutual fund and holding period. Equity funds attract capital gains tax; debt funds are taxed differently based on short-term or long-term capital gains. |
| <b>Inflation Protection</b>      | FDs typically offer returns that may barely beat inflation.   | Equity mutual funds have the potential to provide higher returns that can beat inflation over the long term.  |
| <b>Tenure</b>                    | Fixed tenure ranging from a few days to 10 years.   | Flexible tenure. Investors can stay invested for as long as they like in open-ended schemes. Close-ended schemes have a fixed maturity period.                                  |
| <b>Compounding</b>               | Interest is compounded periodically (quarterly, annually).  | Returns in mutual funds are reinvested, compounding over time, especially with reinvestment of dividends in growth options.   |
| <b>Tax-Saving Option</b>         | Tax-saving FDs under Section 80C have a 5-year lock-in period, providing deductions up to ₹1.5 lakh.            | Equity Linked Savings Scheme (ELSS) mutual funds provide tax benefits under Section 80C with a 3-year lock-in period.   |
| <b>Customization/Flexibility</b> | Limited flexibility. Once the FD is set, the interest rate and tenure cannot be changed.                        | High flexibility in terms of choice of asset allocation (equity, debt, hybrid) and switching between schemes.   |
| <b>Regulation</b>                | Regulated by the Reserve Bank of India (RBI).   | Regulated by the Securities and Exchange Board of India (SEBI).   |
| <b>Best Suited For</b>           | Conservative investors looking for guaranteed returns and safety of capital.                                    | Investors with various risk appetites: conservative for debt funds, moderate for balanced funds, and aggressive for equity funds.   |
| <b>Investment Method</b>         | Lump-sum investment at once.  | Can invest via lump-sum or systematically through a Systematic Investment Plan (SIP).   |
| <b>Exit Load/Penalty</b>         | Early withdrawal attracts a penalty on interest earned.   | Some mutual funds charge an exit load if redeemed before a specific time, but most funds allow withdrawals without penalties after a certain period.                            |
| <b>Returns Expectation</b>       | Typically 4%–7% per annum.  | Varies widely; equity mutual funds can offer 10%–15% returns over the long term, while debt mutual funds offer lower, stable returns.   |
| <b>Capital Protection</b>        | 100% capital protection (for amounts within ₹5 lakh insurance limit).   | No guarantee of capital protection. Investments in equity and hybrid mutual funds may fluctuate based on market conditions.   |

## 11. Model Portfolio

**Model portfolios** are pre-constructed collections of investments designed to suit different investor risk profiles, financial goals, and time horizons. These portfolios are typically

created and managed by financial professionals, such as wealth managers, financial advisors, or mutual fund houses, and are intended to serve as a blueprint for investors looking to diversify their investments according to their preferences and goals.

### Key Features of Model Portfolios:

| Feature                        | Description   |
|--------------------------------|---|
| <b>Diversification</b>         | Includes a mix of asset classes (equity, debt, gold, etc.) to spread risk.                              |
| <b>Risk Profile Based</b>      | Tailored to different risk profiles: conservative, moderate, aggressive.                                |
| <b>Goal-Oriented</b>           | Can be designed to meet specific financial goals, such as retirement or wealth accumulation.            |
| <b>Asset Allocation</b>        | Allocation between asset classes is determined based on the investor's risk tolerance and time horizon. |
| <b>Rebalancing</b>             | Periodic rebalancing is done to maintain the desired asset allocation as markets fluctuate.             |
| <b>Professional Management</b> | Generally created by financial experts based on research and market analysis.                           |
| <b>Customization</b>           | While predefined, model portfolios can often be tweaked to better fit individual investor preferences.  |

### Types of Model Portfolios:

1. **Conservative Portfolio:**
  - Primarily focused on capital preservation with a high allocation to low-risk assets like bonds or fixed-income instruments.
  - Suited for investors with a low-risk tolerance and short-term goals.
2. **Balanced Portfolio (Moderate Risk):**
  - A mix of equities and debt to provide moderate growth with controlled risk.
  - Designed for investors with moderate risk tolerance, aiming for balanced returns over the medium term.
3. **Aggressive Portfolio:**
  - High allocation to equities or other high-risk/high-return assets.
  - Suited for investors with a high-risk appetite and long-term financial goals, seeking higher returns.
4. **Thematic or Goal-Based Portfolios:**
  - Focused on specific investment themes (like technology, clean energy) or financial goals (like retirement, children's education).

### Benefits of Model Portfolios:

- **Simplified Investment:** Model portfolios provide a structured approach to investing, making it easier for investors to diversify without needing in-depth knowledge of individual asset selection.
- **Time-Saving:** Investors can save time by following a pre-built strategy rather than constructing and managing their portfolios from scratch.

- **Risk Management:** They offer a built-in risk management strategy by diversifying across asset classes based on the investor's profile.
- **Professional Guidance:** Leveraging the expertise of financial professionals who have researched and designed these portfolios.

## 12. Step by Step Approach of Building Model Portfolio

Building a **model portfolio** is a systematic process that involves several key steps to ensure that the investments align with an investor's financial goals, risk tolerance, and time horizon. Here's a step-by-step approach to creating a model portfolio:

### Step 1: Define Investment Objectives

The first step in building a model portfolio is to establish the investment goals, which can vary depending on the investor's financial needs. Common goals include:

- **Wealth accumulation**
- **Retirement planning**
- **Capital preservation**
- **Generating income**
- **Saving for a specific goal** (e.g., buying a house, children's education)

The goals will influence the type of investments and the level of risk an investor is willing to take.

### Step 2: Assess Risk Tolerance

Risk tolerance is the level of risk an investor is willing to take to achieve their goals. It can be categorized into three levels:

- **Conservative:** Prioritizes capital preservation over growth.
- **Moderate:** A balanced approach between growth and risk.
- **Aggressive:** Focuses on high growth potential and is willing to take on more risk.

Investors should understand their emotional and financial capacity to handle market volatility, which will guide the asset allocation process.

### Step 3: Determine Investment Horizon

The investment horizon is the length of time an investor expects to hold their investments before needing access to the funds. A longer time horizon generally allows for more exposure to equities (which are riskier but offer higher returns over time), while a shorter horizon favors safer investments like bonds or fixed deposits.

- **Short-term** (1–3 years): Focus on stability, low-risk assets like debt funds.
- **Medium-term** (3–7 years): A mix of equities and bonds.
- **Long-term** (7+ years): Higher equity exposure for growth.

### Step 4: Asset Allocation Strategy

The core of a model portfolio is its asset allocation, which refers to how the portfolio is divided among different asset classes. A proper mix of:

- **Equities (Stocks):** For growth.
- **Debt (Bonds, Fixed Income):** For stability and income.
- **Cash and Cash Equivalents:** For liquidity.
- **Alternative Investments:** Gold, real estate, etc., for diversification.

The proportion of each asset class depends on the investor's risk tolerance and investment horizon. For example:

- **Conservative Portfolio:** 20% equities, 70% bonds, 10% cash.
- **Balanced Portfolio:** 50% equities, 40% bonds, 10% cash.
- **Aggressive Portfolio:** 80% equities, 15% bonds, 5% cash.

### **Step 5: Select Investments Within Asset Classes**

Once asset allocation is determined, the next step is selecting specific investments within each asset class. This involves:

- **Equities:** Selecting a mix of large-cap, mid-cap, and small-cap stocks, or mutual funds/ETFs (Exchange-Traded Funds) that track equity markets.
- **Debt:** Choosing between government bonds, corporate bonds, or debt mutual funds based on risk appetite.
- **Cash:** Holding cash or cash equivalents like money market funds for liquidity.

Diversification within each asset class reduces the risk of underperformance in any single investment.

### **Step 6: Consider Costs and Fees**

When building a model portfolio, it's important to account for costs such as:

- **Management fees:** Charged by mutual funds or ETFs.
- **Transaction fees:** Costs related to buying and selling securities.
- **Taxes:** Capital gains taxes or dividend taxes, which can reduce overall returns.

Minimizing costs will have a positive impact on long-term returns.

### **Step 7: Implement the Portfolio**

Once the investments are chosen, the next step is to implement the portfolio. This can be done through:

- **Lump-sum investment:** Investing a large amount at once.
- **Systematic Investment Plan (SIP):** Investing small amounts regularly over time, which helps in averaging the cost of investments and managing volatility.

### **Step 8: Monitor and Rebalance the Portfolio**

Regular monitoring is necessary to ensure that the portfolio remains aligned with the investor's objectives. Over time, due to market movements, the asset allocation might drift from its target. For example, if equities perform well, their percentage in the portfolio may increase, shifting the portfolio towards higher risk.

- **Rebalancing:** The process of selling over-performing assets and buying underperforming ones to bring the portfolio back to its intended asset allocation. Rebalancing can be done annually or whenever the asset mix deviates significantly from the target.

### **Step 9: Adjust for Changing Goals and Market Conditions**

As the investor's life circumstances change, so may their goals and risk tolerance. For example, as retirement approaches, an investor might shift from an aggressive portfolio to a more conservative one to protect their capital.

- Adjust the portfolio's asset allocation as needed to match evolving goals and risk preferences.
- Stay informed about changes in market conditions that may warrant changes in the portfolio.

## **13. Behavioural Biases in Investment Decisions**

Behavioural biases significantly impact investment decision-making, often leading investors to make irrational choices that deviate from what would be considered optimal or rational behaviour in economic theory. Understanding these biases can help investors make better decisions and avoid common pitfalls.

### **1. Overconfidence Bias**

- **Description:** Investors often believe they know more than they do and can outperform the market.
- **Impact:** This can lead to excessive trading and taking on more risk than necessary.

### **2. Loss Aversion**

- **Description:** Investors fear losses more than they value gains.
- **Impact:** They may hold onto losing investments too long and sell winning ones too early.

### **3. Herd Behavior**

- **Description:** Investors follow the crowd, buying or selling based on what others do.
- **Impact:** This can cause asset bubbles or market crashes.

### **4. Anchoring Bias**

- **Description:** Investors rely too heavily on the initial price at which they bought a stock.

- **Impact:** This can lead to holding onto underperforming stocks, ignoring their current value.

## 5. Confirmation Bias

- **Description:** Investors seek information that confirms their existing beliefs and ignore contrary evidence.
- **Impact:** This can lead to poor decisions as they overlook critical risks.

## 6. Recency Bias

- **Description:** Investors give too much weight to recent events or trends.
- **Impact:** This can result in buying high or selling low based on short-term performance.

## 7. Familiarity Bias

- **Description:** Investors prefer familiar investments, such as local companies.
- **Impact:** This can lead to a lack of diversification and increased risk.

## 8. Status Quo Bias

- **Description:** Investors prefer things to stay the same and resist change.
- **Impact:** This can prevent necessary adjustments in their investment strategies.

## 9. Endowment Effect

- **Description:** Investors value an asset more just because they own it.
- **Impact:** They may hold onto underperforming assets due to overvaluation.

## 10. Mental Accounting

- **Description:** Investors categorize money into different “accounts” based on subjective criteria.
- **Impact:** This can lead to inconsistent and irrational financial decisions.