

CWMP — Paper 2 – Investment Planning, Asset Management and Regulatory Environment

Complete Book | Table of Contents | 26 chapters + 8 sections

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CH-1

Investment Objectives, Constraints and Suitability

Topic 1 — Engaging Investment Clients and the Initial Client Interview

- **Engagement** — The adviser and client agree to work together and settle the terms of the relationship.
- **Scope** — The adviser explains the services, the advice process, fees and how reviews will happen.
- **Engagement letter** — A written agreement records scope, duties, fees, duration and termination.
- **Disclosure** — Conflicts of interest, commissions and limits of the advice are disclosed upfront.

The initial client interview

- 1. **Build rapport** — Put the client at ease and explain the adviser's role and approach.
- 2. **Explain services and costs** — Cover fees, conflicts and confidentiality of client information.
- 3. **Discover goals** — Use open-ended questions on goals, concerns, values and priorities.
- 4. **Explore attitudes** — Ask about investing experience, past losses and reactions to market falls.
- 5. **Agree next steps** — List the documents required and fix a timeline for the plan.
- **Avoid leading questions** — A question that suggests the answer distorts the client's true view.

Requirement	Position for a SEBI-registered investment adviser (IA Regulations, 2013, as amended)
Client agreement	Agreements with clients, on terms specified by SEBI, must be kept on record.
Segregation	An individual adviser and the adviser's family cannot distribute products. A non-individual adviser's group cannot give both advice and distribution to the same client.
Fees	Charged only in the manner SEBI specifies; no implementation fee may be charged.
Records	Kept for at least 5 years , including the risk profile and the suitability assessment for each advice.

Remember this

- Advice and distribution stay separate: one client cannot get both from the same IA group. Records: at least 5 years.

Topic 2 — Investor Personalities

Personality models help the adviser predict how a client will take decisions and react to risk.

BB&K five-way model — two axes: confidence (confident–anxious) and method of action (careful–impetuous)

Type	Confidence	Method	Typical behaviour
Adventurer	Confident	Impetuous	Strong views, takes big bets, hard to advise
Celebrity	Anxious	Impetuous	Follows trends and tips; fears missing out; prone to churning
Individualist	Confident	Careful	Independent and analytical; does own research
Guardian	Anxious	Careful	Cautious, often near retirement; values safety over growth
Straight Arrow	Centre	Centre	Balanced, average investor; medium risk

Two-way (passive–active) model

Basis	Passive investor	Active investor
Source of wealth	Inheritance or salaried career; little own capital risked	Built through own enterprise by risking own capital
Need for security	High	Lower
Risk tolerance	Lower	Higher
Wants control	Prefers to delegate	Wants to be involved; may be overconfident

Remember this

- Guardian = anxious + careful; Adventurer = confident + impetuous. Active investors risked their own capital to build wealth.

Topic 3 — Gathering Client Data

Data type	Examples	Usual source
Quantitative	Income, expenses, assets, loans, insurance cover, existing investments, tax status	Salary slips, bank and demat statements, Consolidated Account Statement, tax returns, Annual Information Statement
Qualitative	Goals, values, attitude to risk, investing experience, family, health, ethical or ESG preferences	Interview and fact-find questionnaire

- **Fact-find** — A structured form ensures no key item is missed in the first meetings.
- **Verification** — Figures given orally are checked against statements and documents.
- **Confidentiality** — Client data are used only for the agreed purpose and kept secure.
- **Data protection** — Client data are personal data under the DPDP Act, 2023. Most duties under the DPDP Rules, 2025 apply in phases from 13 Nov 2026 and 13 May 2027, after the exam cut-off.

Remember this

- Fact-find = numbers (quantitative) + feelings (qualitative). Both are needed for a suitability decision.

Topic 4 — Risk Tolerance and Suitability: Determining Investor Risk Tolerance

- **Risk tolerance** — The amount of variability or loss a client can accept while pursuing returns.
- **Suitability** — Advice fits the client's risk tolerance, objectives, finances, knowledge and experience.

Component	Meaning	Driven by
Willingness (risk attitude)	Psychological readiness to accept volatility and loss	Personality, experience, knowledge, emotions
Ability (risk capacity)	Financial capacity to absorb losses without harming goals	Time horizon, income stability, wealth relative to needs, liquidity, dependants, insurance
Need (required risk)	Risk needed to earn the return the goals require	Goal size, current corpus, savings rate
Risk perception	How risky the client believes a product is	Recent events, framing, familiarity

- **Higher ability** — Long horizon, stable income, low debt, adequate emergency fund and insurance.
- **Lower ability** — Short horizon, dependants, irregular income, large loans or a near-term goal.

- **Conflict rule** — Where willingness and ability differ, the lower of the two normally governs.
- **Education** — If willingness is below ability, the adviser explains the cost of being too cautious.

Example: Ms Iyer (30), a software engineer with no loans, has high ability. She sold all her equity in a 2020 market fall, showing low willingness. The adviser starts with a moderate allocation and educates her.

Remember this

- Ability is objective; willingness is subjective. When they conflict, follow the more conservative one.

Topic 5 — Risk Tolerance Questionnaires

- **Purpose** — A questionnaire converts a client's answers into a risk score and a risk category.
- **Question types** — Horizon, reaction to a loss scenario, choice of return ranges, experience, income stability.
- **Validity** — It must measure risk tolerance, not financial knowledge or mood.
- **Reliability** — The same client should get a similar score when tested again.
- **Limitations** — Answers swing with recent market moves, framing and overconfidence; an interview must support them.

Score band (illustrative firm policy)	Risk category	Indicative equity share
Lowest	Conservative	0–20%
Low	Moderately conservative	20–40%
Middle	Moderate	40–60%
High	Moderately aggressive	60–80%
Highest	Aggressive	80–100%

Remember this

- SEBI IA Regulation 16: questionnaires must be fair, clear and not misleading — no vague wording, double negatives, complex language or leading questions; the risk profile is told to the client and updated periodically.

Topic 6 — Suitability Using Risk Tolerance Information

Rule	What it requires
SEBI IA Regulation 16 (risk profiling)	Collect age, objectives, horizon, income, investments, risk appetite and liabilities; assess willingness and ability, including capacity to absorb loss.
SEBI IA Regulation 17 (suitability)	Advice must suit the risk profile, with a documented selection process and a reasonable basis that it meets objectives, risk-bearing ability, experience and knowledge. Complex products need a closer fit.
Mutual fund riskometer	Six levels: Low, Low to Moderate, Moderate, Moderately High, High and Very High. Reviewed monthly; used to match scheme risk to client profile.
RBI mis-selling rules (issued 15 Jun 2026; effective 1 Jan 2027 — after the exam cut-off)	Banks assess suitability and appropriateness before selling products not suitable for all customers; explicit consent; no compulsory bundling; full refund if mis-selling is established.

1. **Profile** — Classify the client's risk category from questionnaire and interview.
2. **Map** — Link the category to a model asset allocation.
3. **Select** — Choose products whose risk level fits the allocation.

4. **Document** — Record why each recommendation suits the client.
5. **Review** — Reassess after life events and at regular intervals.

Example: A client profiled 'Moderate' should not hold a 'Very High' sectoral fund as a core holding. A small, documented satellite holding can still fit within the overall moderate allocation.

Remember this

- Suitability = right product + right client + right reason, documented for each advice.

Topic 7 — Matching Return Expectations with Risk Tolerance

- **Required return** — The return the client must earn to meet goals; it is a need.
- **Desired return** — The return the client would like; it is a wish.
- **Real return** — Return after inflation; goals are best expressed in real terms.
- **After-tax return** — What the client actually keeps; compare products after tax.
- **Mismatch** — If the required return exceeds what the risk tolerance allows, change the goal, horizon or savings, not the risk.

$$(1 + R_{nominal}) = (1 + R_{real}) \times (1 + i)$$

N1. [Numerical] Mr Rao (60) has a corpus of ₹1.5 crore. He wants ₹9 lakh a year in today's money, rising with 5% inflation, without eating into the real value of the corpus. His moderate risk profile suits a portfolio expected to earn 9.5%. Is the goal realistic?

Item	Value
Corpus	₹1,50,00,000
Spending (real)	₹9,00,000 a year
Inflation	5%
Expected return (moderate portfolio)	9.5%

Solution:

Formula:

$$R_{real} = \frac{\text{Spending}}{\text{Corpus}}$$

Required real return = $9,00,000 \div 1,50,00,000 = 6.0\%$.

$$R_{nominal} = 1.06 \times 1.05 - 1 = 11.3\%$$

Real return of the moderate portfolio = $1.095 \div 1.05 - 1 = 4.29\%$.

Sustainable spending = $4.29\% \times ₹1.5 \text{ crore} = ₹6,42,857$.

Answer: He needs 11.3% but his profile supports 9.5%. Cut spending to about ₹6.43 lakh, or accept a gradual draw on capital — not a riskier portfolio.

Remember this

- Never push risk beyond tolerance to chase a goal — change the goal, timeline or savings instead.

Topic 8 — Risk-Return Application

- **Trade-off** — Higher expected return comes with higher variability of return.
- **Minimum acceptable return** — A threshold the client does not want to fall below, such as inflation or a fixed spending need.
- **Safety-first rule** — Choose the portfolio with the lowest chance of falling below the threshold.

Asset class	Return potential	Volatility	Main risks
Cash, liquid funds	Low	Very low	Inflation, reinvestment
Government securities	Low to moderate	Low to moderate	Interest rate, inflation
Corporate bonds	Moderate	Low to moderate	Credit, liquidity, interest rate
Large-cap equity	High	High	Market, business
Small-cap equity	Higher	Very high	Market, liquidity, business
Gold	Moderate	Moderate to high	Price, exchange rate

$$SFR = \frac{E(R_p) - R_L}{\sigma_p}$$

N2. [Numerical] A client's minimum acceptable return is 4%. Three model portfolios are offered. Which best meets the safety-first rule, and what is the chance of a return below 4% (assuming normal returns)?

Item	Value
Portfolio A	E(R) 8%, σ 6%
Portfolio B	E(R) 11%, σ 12%
Portfolio C	E(R) 14%, σ 20%
Threshold (R_L)	4%

Solution:

Formula:

$$SFR = \frac{E(R_p) - R_L}{\sigma_p}$$

A: $(8 - 4) \div 6 = 0.667$; chance below 4% = 25.2%.

B: $(11 - 4) \div 12 = 0.583$; chance below 4% = 28.0%.

C: $(14 - 4) \div 20 = 0.500$; chance below 4% = 30.9%.

Answer: Portfolio A has the highest SFR (0.667) and the lowest shortfall probability (25.2%), though C has the highest return.

Remember this

- Highest safety-first ratio = lowest probability of missing the threshold return.

Topic 9 — Potential Tax Issues

- New law** — The Income-tax Act, 2025 applies from 1 April 2026; 'tax year' replaces previous year and assessment year. Income up to 31 March 2026 stays under the 1961 Act.
- Regime choice** — The new regime is the default; deductions such as section 123 (earlier 80C, ₹1.5 lakh) need the old regime.
- Tax drag** — Frequent switching turns long-term gains into short-term gains taxed at higher rates.
- Holding period** — Listed securities become long-term after 12 months; most other assets after 24 months.
- Loss harvesting** — Booking losses to offset gains works only within the set-off rules below.
- Asset location** — Place heavily taxed income in tax-efficient vehicles such as PPF (exempt interest).

Changes by the Finance Act, 2026 (from 1 April 2026)

- Buy-back** — Buy-back proceeds are taxed as capital gains, not as dividend; promoters pay an additional tax.
- No expense deduction** — No expense, including interest, is deductible against dividend or mutual fund income.
- SGB redemption** — The exemption on redemption applies only to bonds bought at original issue and held to maturity.
- STT on F&O** — Futures 0.05% (from 0.02%); options premium 0.15% (from 0.1%).

Loss	Can be set off against	Carry forward
Short-term capital loss	Short-term or long-term capital gains	8 tax years
Long-term capital loss	Long-term capital gains only	8 tax years
Capital loss vs other heads	Not allowed (not against salary or interest)	—

Remember this

- Loss carry-forward needs a return filed by the due date. A long-term loss can never reduce a short-term gain.

Topic 10 — Taxability of a Portfolio

Holding	Tax treatment in Tax Year 2026-27
Bank interest (savings, FD)	Slab rate. Banks deduct TDS at 10% when interest exceeds ₹50,000 a year (₹1 lakh for senior citizens).
Dividends	Slab rate. TDS at 10% when dividends from one payer exceed ₹10,000 a year.
Listed equity and equity-oriented funds (STT paid)	Up to 12 months: STCG 20%. Over 12 months: LTCG 12.5% on gains above ₹1.25 lakh a year.
Debt-oriented mutual funds (over 65% in debt) bought on or after 1 Apr 2023	Always short-term; taxed at slab rate whatever the holding period.
Listed bonds and debentures	Interest at slab rate. Gains after 12 months: LTCG 12.5% without indexation.
Unlisted bonds and debentures	Gains always short-term at slab rate (transfers from 23 Jul 2024).
Land, buildings, unlisted shares	Over 24 months: LTCG 12.5% without indexation. For land or buildings bought before 23 Jul 2024, resident individuals and HUFs pay the lower of this and 20% with indexation.
PPF	Interest and maturity exempt; deduction for deposits only in the old regime.

Example: A tax-free bond yields 6%. For a client in the 30% slab with 4% cess (31.2%), the taxable-equivalent yield is $6 \div (1 - 0.312) = 8.72\%$. A 7.25% FD gives only 4.99% after tax, so the tax-free bond is better.

$$TEY = \frac{R_{tax\ free}}{1 - t}$$

N3. [Numerical] Mrs Batra (new regime, income above ₹24 lakh, no surcharge) has these portfolio items in Tax Year 2026-27. Find the tax, including 4% cess.

Item	Value
STCG on listed shares (STT paid)	₹80,000
LTCG on equity funds	₹2,00,000
FD interest	₹1,00,000
Dividends	₹40,000
Marginal slab rate	30%

Solution:

STCG tax = $80,000 \times 20\% = ₹16,000$.

LTCG tax = $(2,00,000 - 1,25,000) \times 12.5\% = ₹9,375$.

Tax on FD interest and dividends = $1,40,000 \times 30\% = ₹42,000$.

Tax before cess = $16,000 + 9,375 + 42,000 = ₹67,375$.

Cess = $4\% \times 67,375 = ₹2,695$.

Answer: Total tax ₹70,070.

Remember this

- Equity: 12 months; STCG 20%; LTCG 12.5% above ₹1.25 lakh. Debt funds bought from 1 Apr 2023: always slab rate.

**Topic 11 — Understanding Life Stages**

Life stage	Typical position	Investment focus	Risk capacity
Accumulation (early career)	Low net worth, rising income, loans, young dependants	Growth, emergency fund, insurance, SIPs	High (long horizon)
Consolidation (mid to late career)	Income exceeds spending; peak earnings; loans falling	Growth with income; retirement corpus; children's education	Moderate to high
Spending (retirement)	Lives on pension and portfolio	Regular income, capital preservation, inflation and longevity protection	Lower
Gifting (estate)	Assets exceed lifetime needs	Wealth transfer, will, nominations, trusts, charity	Depends on heirs' horizon

- **Life events** — Marriage, a child's birth, a job change, inheritance, divorce, death or retirement all trigger a review.
- **Not age alone** — A 45-year-old with no dependants may have more capacity than a 35-year-old with heavy loans.

Remember this

- Life-stage order: Accumulation → Consolidation → Spending → Gifting.

Topic 12 — Establishing Goals, Timelines and SMART Goals

- **Horizon** — Short-term goals (up to about 3 years) suit liquid and short debt funds; long-term goals (7 years and more) can carry more equity.
- **Priority** — Needs (retirement, education) come before wants (a bigger car) and wishes (a holiday home).

Letter	Meaning	Test	Example
S	Specific	Is the goal clearly defined?	Fund Aarav's engineering degree
M	Measurable	Is there an amount?	₹25 lakh in today's money
A	Achievable	Can surplus cash flow support it?	SIP fits within monthly surplus
R	Relevant	Does it fit the client's priorities?	Education is a top family priority
T	Time-bound	Is there a deadline?	By April 2036 (10 years)

N4. [Numerical] Aarav's degree costs ₹25 lakh today. Education costs rise 8% a year. How much monthly SIP (end of month) is needed for 10 years if the portfolio earns 12% a year (1% a month)?

Item	Value
Cost today	₹25,00,000
Education inflation	8% a year
Period	10 years = 120 months
Return	1% a month

Solution:

Formula:

$$FV = PV \times (1 + i)^n$$

$$SIP = \frac{FV \times r}{(1 + r)^n - 1}$$

Future cost = $25,00,000 \times 1.08^{10} = ₹53,97,312$.

Annuity factor = $(1.01^{120} - 1) \div 0.01 = 230.04$.

SIP = $53,97,312 \div 230.04 = ₹23,463$.

Answer: A monthly SIP of about ₹23,463 for 10 years.

Remember this

- SMART = Specific, Measurable, Achievable, Relevant, Time-bound.

Topic 13 — Defining and Determining Investment Objectives

- **Return objective** — States the required or desired return; nominal or real, before or after tax.
- **Risk objective** — States the risk limit; absolute (for example, no more than a 15% fall in a year) or relative (tracking error against a benchmark).

Objective	Return	Risk	Usually suits
Capital preservation	Low	Very low	Emergency fund, near-term goals
Current income	Moderate, steady	Low to moderate	Retirees needing cash flow
Growth and income (balanced)	Moderate	Moderate	Mid-career investors
Growth	High	High	Long horizon, high capacity
Aggressive growth / speculation	Very high	Very high	Small part of a large portfolio

Constraints — TTLU

Constraint	Example
Time horizon	Daughter's wedding in 18 months
Taxes	30% slab; preference for exempt or long-term gains
Liquidity	₹30 lakh needed for the wedding; emergency fund of 6 months' expenses
Legal and regulatory	A trust deed bars derivatives; an NRI faces FEMA limits
Unique circumstances	Ethical exclusions, concentrated employer stock, health needs

Remember this

- Objectives = Return + Risk. Constraints = TTLU (Time, Taxes, Liquidity, Legal, Unique).

Topic 14 — Investment Policy Statement (IPS)

- **Meaning** — An IPS is a written document that sets the client's objectives, constraints and the rules for managing the portfolio.
- **Discipline** — It keeps the client and adviser on plan during market panic or euphoria.
- **Accountability** — It sets the benchmarks and review process for judging performance.

Section	Contents
Client description and purpose	Who the client is and why the IPS exists
Duties and responsibilities	Roles of client, adviser, custodian and others
Objectives and constraints	Return and risk objectives; TTLU constraints
Investment guidelines	Permitted and prohibited assets, leverage and derivatives
Strategic asset allocation	Target weights and rebalancing ranges
Evaluation and review	Benchmarks, reporting and review frequency

Example: IPS for Mr and Mrs Menon (55, 52): required return 9%; maximum one-year fall 12%; horizon 25 years; ₹20 lakh liquidity in 2 years; target 50% equity (±5%), 40% debt, 10%



gold; annual review against a blended benchmark.

Remember this

- Review the IPS at least once a year and after any major life event. It holds no market forecasts.

CWMP | Module A | CH-1 | MCQs

Q1. A non-individual SEBI-registered investment adviser has a group company that distributes mutual funds.

Advisory client Mr Bhalla asks the group to also sell him the funds it recommends. Which is correct? [Ref: Topic 1, p. 2]

- (a) It is allowed once Mr Bhalla signs a written consent letter for both services
- (b) The same client cannot get both advisory and distribution services within the group
- (c) It is allowed if the distribution company waives all commission on the sale
- (d) It is allowed only if the funds recommended are direct plans of the schemes

Q2. Mrs Sen, 61, a retired teacher, worries constantly about losses, studies every option slowly and dislikes volatility. Under the BB&K model she is most likely a: [Ref: Topic 2, p. 2]

- (a) Celebrity
- (b) Individualist
- (c) Guardian
- (d) Adventurer

Q3. A client's family trust deed bars derivatives, and her daughter's wedding in 18 months will need ₹30 lakh. These two facts are, in order: [Ref: Topic 13, p. 5]

- (a) A legal constraint and a liquidity constraint
- (b) A unique circumstance and a tax constraint
- (c) A risk objective and a return objective
- (d) A liquidity constraint and a legal constraint

Q4. Which of the following is qualitative data collected in a client fact-find? [Ref: Topic 3, p. 2]

- (a) The outstanding balance and EMI on the client's home loan
- (b) The annual premium paid on the client's term insurance policy
- (c) The mutual fund holdings shown in the Consolidated Account Statement
- (d) The client's preference to avoid tobacco and liquor companies

Q5. Rohit, 28, single, has a secure government job, no loans and a ₹10 lakh emergency fund, but sold all his equity in panic when markets fell 20%. His risk profile is best described as: [Ref: Topic 4, p. 2]

- (a) High willingness and low ability
- (b) Low willingness and high ability
- (c) High willingness and high ability
- (d) Low willingness and low ability

Q6. Mrs Pillai, a 66-year-old retiree with a modest corpus and no pension, wants 80% in small-cap funds after a friend's gains. The adviser should: [Ref: Topic 4, p. 2]

- (a) Base the allocation on her lower risk capacity and explain the reason
- (b) Follow her stated preference, because her willingness to take risk is high
- (c) Recommend the 80% small-cap allocation but add a stop-loss instruction
- (d) Decline to advise her until she gives up the small-cap idea entirely

Q7. Which of the following are consistent with SEBI's risk-profiling requirements for investment advisers?

- I. Questions avoid double negatives and leading wording.
- II. The client is told the risk profile after the assessment.
- III. The risk score is withheld from the client to avoid bias.
- IV. Client information is updated periodically. [Ref: Topic 5, p. 3]

- (a) I and III only
- (b) II, III and IV only
- (c) I, II and IV only
- (d) I, II, III and IV

Q8. A bank relationship manager proposes a 'Very High' riskometer sectoral fund as the core holding for a customer profiled 'Low to Moderate'. The proposal is: [Ref: Topic 6, p. 3]

- (a) Suitable, provided the scheme's past three-year return has been high
- (b) Suitable, provided the customer signs an acknowledgement of the risk
- (c) Outside suitability rules, because it is a distribution transaction
- (d) Unsuitable, because the scheme's risk level does not match the profile

Q9. A client needs a real return of 4% a year. Expected inflation is 6%. Using the exact relationship, the required nominal return is: [Ref: Topic 7, p. 3]

- (a) 10.00%
- (b) 1.92%
- (c) 10.24%
- (d) 2.00%

Q10. A client's minimum acceptable return is 5%. Portfolio P: E(R) 9%, σ 8%. Portfolio Q: E(R) 12%, σ 14%. Portfolio R: E(R) 7%, σ 3%. Under the safety-first rule, the client should choose: [Ref: Topic 8, p. 3]

- (a) Portfolio R, with a ratio of 0.67
- (b) Portfolio Q, because its expected return is highest
- (c) Portfolio P, because its ratio is 0.50
- (d) P or Q, because their ratios are equal at 0.50

Q11. In Tax Year 2026-27 Mr Gill has a short-term capital loss of ₹1,20,000 on listed shares and a long-term capital gain of ₹3,00,000 on listed shares (STT paid). His tax on the gain, before cess, is: [Ref: Topic 9, p. 4]

- (a) ₹21,875
- (b) ₹6,875
- (c) ₹22,500
- (d) Nil, as a short-term loss cannot be set off against a long-term gain

Q12. Which of these is taxed at the slab rate regardless of how long it is held? [Ref: Topic 10, p. 4]

- (a) Listed equity shares (STT paid) sold after being held for fourteen months
- (b) Units of an equity-oriented mutual fund held for three years and redeemed
- (c) Listed non-convertible debentures sold after being held for eighteen months
- (d) Units of a debt-oriented mutual fund (over 65% in debt) bought in June 2024

Q13. Mr and Mrs Arora, 48 and 45, are at peak earnings, have almost repaid their home loan, will pay college fees soon and plan to retire in 12 years. Their life stage is: [Ref: Topic 11, p. 5]

- (a) Consolidation
- (b) Early accumulation
- (c) Spending
- (d) Gifting

Q14. Which goal statement meets all the SMART criteria? [Ref: Topic 12, p. 5]

- (a) Become wealthy enough to retire in comfort and travel widely in the coming years
- (b) Invest in top-rated equity funds every month and review them when markets fall
- (c) Build ₹54 lakh for a son's engineering degree by April 2036 via a ₹23,500 monthly SIP
- (d) Save the maximum amount possible every year for the children's higher studies

Q15. Which of the following would NOT normally be part of an Investment Policy Statement? [Ref: Topic 14, p. 5]

- (a) Strategic asset allocation with permitted rebalancing ranges
- (b) A forecast of the Nifty 50 level to be reached by the end of the year
- (c) Duties and responsibilities of the client and the adviser
- (d) Benchmarks for evaluation and the frequency of review

Answer key

Q	Ans	Q	Ans	Q	Ans	Q	Ans	Q	Ans
1	b	4	d	7	c	10	a	13	a
2	c	5	b	8	d	11	b	14	c
3	a	6	a	9	c	12	d	15	b

CH-2

Principles of Investment Risk

Topic 1 — Total Risk

- **Meaning** — Risk is the chance that the actual return will differ from the expected return.
- **Total risk** — The full variability of an investment's return, measured by standard deviation.
- **Two parts** — Total risk = systematic (market) risk + unsystematic (specific) risk.
- **Diversification** — Adding securities from different sectors removes most specific risk; roughly 20–30 well-spread stocks remove most of it.
- **Reward** — The market pays a premium only for systematic risk, because specific risk can be diversified away at no cost.

$$\sigma_i^2 = \beta_i^2 \sigma_m^2 + \sigma_e^2$$

Here $\beta_i^2 \sigma_m^2$ is systematic variance and σ_e^2 is unsystematic (residual) variance.

Basis	Systematic risk	Unsystematic risk
Other names	Market, non-diversifiable	Specific, diversifiable, idiosyncratic
Source	Economy-wide factors	Company or industry factors
Diversification	Cannot remove it	Can largely remove it
Measure	Beta	Residual variance; part of standard deviation
Rewarded by market	Yes	No

Remember this

- Total risk (σ) = systematic (β) + unsystematic. Only systematic risk earns a risk premium.

Topic 2 — Types of Investment-Related Risk

Investment risks fall into two families. The mnemonic **PRIME** lists the systematic risks.

Systematic (PRIME)	Unsystematic
Purchasing power (inflation) risk	Business risk
Reinvestment rate risk	Financial (leverage) risk
Interest rate risk	Default (credit) risk
Market risk	Liquidity and marketability risk
Exchange rate risk	Regulatory, tax, management and event risk

- **Country and political risk** — Systematic for a domestic investor, but diversifiable for a global investor who spreads money across countries.
- **Call (prepayment) risk** — The issuer redeems a callable bond early when rates fall, forcing reinvestment at lower yields.

- **Concentration risk** — Too much in one stock, sector or issuer; common with employer shares and inherited holdings.
- **Sequence-of-returns risk** — Poor returns in the first years of withdrawals deplete a retirement corpus faster.
- **Downside view** — Investors fear losses more than gains, so downside measures are also used.

Remember this

- **PRIME** = Purchasing power, Reinvestment, Interest rate, Market, Exchange rate — all systematic.

Topic 3 — Systematic Risk

Risk	Meaning	Indian illustration
Purchasing power	Inflation erodes the real value of returns; fixed-income holders are hit most	An FD at 7% gives 4.82% after 31.2% tax; with 6% inflation the real return is negative
Reinvestment rate	Coupons and maturing sums are reinvested at lower rates	A retiree's maturing deposits are renewed at lower rates after RBI cuts the repo rate
Interest rate	Bond prices fall when yields rise; longer duration means more risk	A 10-year G-sec fund loses value when yields rise
Market	Broad market falls drag down almost all stocks	The March 2020 pandemic sell-off hit nearly every sector
Exchange rate	Currency moves change the home-currency value of foreign assets	A US fund's rupee return rises when the rupee weakens

- **Opposite pulls** — Rising rates raise reinvestment income but cut bond prices; falling rates do the reverse.
- **Zero-coupon bonds** — They carry no reinvestment risk until maturity, but the highest price risk for their maturity.
- **Managing it** — Asset allocation, duration control, index hedges and gold can reduce, not remove, systematic risk.

Remember this

- Interest rate risk and reinvestment risk move in opposite directions when rates change.

Topic 4 — Nonsystematic Risk

Risk	Meaning	Example
Business	Uncertainty in revenue and operating profit from the firm's line of business	A telecom firm loses subscribers to a rival
Financial	Extra risk from using debt (leverage)	A highly geared infra company's profit swings with interest costs
Default (credit)	Issuer fails to pay interest or principal on time	An NBFC delays interest on its NCDs
Liquidity	Cannot be sold quickly without a price concession or loss of principal	A thinly traded small-cap share
Marketability	Cannot be sold quickly at all	A flat or an unlisted share
Regulatory and tax	Rule or tax changes hit one industry or product	A ban or new levy on one product category
Management and event	Poor decisions, fraud, accidents or lawsuits	A plant fire or an accounting fraud

- **Marketable but not liquid** — A listed share can be sold in seconds, yet perhaps only at a loss.