Business Standard

Protect your capital while investing

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Use a range of investment options to get an assured return even as you shelter your principal

Warren Buffet, the legendary investor, says: “Be greedy when everyone is fearful and be fearful when everyone is greedy.” However, it is very difficult for the average investor to apply this gospel in practice. He or she usually invests at market peaks during times of exuberance, following the herd and ends up with burnt fingers, vowing never to look at a capital market again.

One reason why a majority of household savings opt for safe havens like bank deposits, postal savings and so on is the fear of losing money in the equity markets. What most people do not realise is that it is possible to gain from the equity markets without losing one’s capital. This can be done by creating one’s own capital-protected product. The investment could be in varied instruments from equities, mutual funds to even postal savings schemes.s

Lets understand the concept using an illustration. You have '1 lakh to invest for five-six years. You can keep your capital safe by investing in a fixed return product in such a proportion that it gives you a maturity equal to your initial investment at the end of the investment period.

If you are comfortable with risking some amount of your capital, you can increase the proportion allocated to an equity/mutual fund. This is the simplest way of hedging your risk. The table (spreading your capital) shows the spectrum of investment options from low risk to high risk. The example uses just two products- fixed deposits (FDs) and National Savings Certificates (NSCs).

In practice, you could use any financial product that has a low to no risk structure and gives an assured return in a fixed period of time.

Spreading your capital using SIP options

Another simple way is to invest the entire amount in a product like the Post Office Monthly Income Scheme (postal MIS) and route the monthly outflow by systematic investment plans (SIPs) in equity diversified mutual funds.

At eight percent rate of interest, for a six-year tenure, your monthly outflow from the Postal MIS on Rs 1 lakh would be RS 667. On maturity, it would give you a total of Rs 1.05 lakh. If you were to invest your monthly outflow of Rs667 in a SIP that gives you a 12 percent rate of return, you would have got Rs 69,841 by the end of six years.

By the end of the tenure of the MIS product, you will have earned your principal back, with a five per cent bonus and a decent re-run from the SIP.

Your total earnings from the MIS and SIP would be Rs 174,841. Senior citizens earn a higher interest rate on bank deposits. If a bank gives more than an eight per cent (the rate of interest on postal MIS) rate on the FD, they can get a better return with the bank deposit, especially if they are in the lower tax bracket.

Similarly, senior citizens could earn from the five year Senior Citizen Savings Scheme (SCSS) which will give out quarterly payouts of Rs 2250 at nine percent though there is no bonus added to the principal.If not being used for routine expenses, the same could be routed to quarterly SIPs to increase the returns. In five years, at a 12 percent rate of return, it would amount to Rs 60,458.

Product	Amt (Rs)	Rate (%)	Returns (Rs)	Total maturity (Rs)
FD	100000	7	151644	151644
FD	66000	7	100085	-
Equity/MF	34000	12	67110	167195
NSC	62500	8	100527	-
Equity/MF	37500	12	74018	174546
Equity/MF	100000	12	197382	197382

*For sake of simplicity, the taxation part has not been considered here.
The rate of return on equity is assumed to be 12%,
but may vary as per the market performance. The tenure is 6 years

Derivatives
If you wish to have a little more sophistication in your investment, you could use derivatives, underlaid by indices, stocks, gold and so onwith a fixed return product.

In case of a moderately bullish view on the market, one strategy that can be used to protect the downside (only, remember the upside also gets restricted) is to buy a call (long call) at current market levels and sell a call (short call) for a higher strike price on the same underlying asset for the same expiration date.

Let us take an example: Buy Nifty 6,200, June 30; call premium, 415. Sell Nifty 6,900, June 30; call premium, 195.

The table (derivative strategy) shows the scenario at different market levels for the above strategy when the market goes up as anticipated:

Executing the strategy
Buy one Nifty 6,200, June 30 call European (CE), at premium 415. Total premium paid =1x50x415= Rs 20,750.

Sell three Nifty 6,900, June 30 CE,at premium 195. Total premium received= 3x50x195=Rs 29,250.

So, you earn Rs 8,500 on these two trades. When the market approaches 6,900-levels, start unwinding your positions. Thus, you can make a profit of (1x50x285)+(3x50x195)=Rs 43,500. If the market falls below 6,200, you lose 1x50x220=Rs 11,000. You already have Rs1lakh, which can be invested in a fixed return product with low/no risk. Thus, you get a capital-plus kind of return.

DERIVATIVE STRATEGY

NIFTY SPOT	Long call	Short call	Premium for long call	Premium for short call	Profit on long call	Profit on short call	Total Profit
6100	6200	6900	415	195	-415	195	-220
6500	6200	6900	415	195	-415	195	-220
6600	6200	6900	415	195	-15	195	180
6700	6200	6900	415	195	85	195	280
6800	6200	6900	415	195	185	195	380
6900	6200	6900	415	195	285	195	480
7000	6200	6900	415	195	385	95	480
7100	6200	6900	415	195	485	-5	480
7200	6200	6900	415	195	585	-105	480

You have to keep in mind:
When calculating profits/losses, do include brokerage and other statutory charges;

Lot sizes may differ with different underlyings;

You should unwind both positions simultaneously when making profit as you had targeted.

Please refer to your broker for exact transactional details. The data provided here is to explain the concept and may not necessarily be accurate.

The writer is a certified financial planner