SSELECTIVVELLY-Invest Classification Scheme for Investment Products

by Sundar Sankaran[1]

The ever widening range of products cooked-up in the financial market poses a huge challenge to balanced investment decisions. SSELECTIVVELLY-Invest is an attempt to develop an investment product classification system.

Why a Standard Classification Scheme is Essential

Rocket scientists, software engineers and creative finance professionals have contributed immensely to product complexity in the financial market. Catchy products and services are slickly marketed to gullible investors. At times, even knowledgeable investors fall for them.

If investment products were to be described along a standard classification system, the process of investment will be simplified significantly. Investors can ensure that all relevant factors and consequential risks are considered before taking an investment decision.

This article proposes a framework that can be used in evaluating complex financial products; thereafter, a simplified framework is suggested for simpler financial products.

SSELECTIVVELLY-Invest

Investors need to look through the prism of the following factors before investing in complex financial products:

¾ *Source (Issuer)*
Identifying the issuer can get quite tricky when the promoter/s run a maze of companies with similar sounding names. But investors should have clarity on which specific legal entity is responsible for returning their money (and paying a return) to them, or on whose performance the value of the investment depends.

¾ *Sector*
Investors should diversify between sectors to minimize risk.

¾ *Exposure (Asset Class)*
Broadly, is it an exposure to debt, equity, gold, real estate, art, commodity etc.?

¾ *Liquidity*
Liquidity is obviously a significant factor for short term investments. Even when it comes to longer term investments e.g. real estate, liquidity may entail a steep price in the form of a discount on the market price if the owner wants to sell.

¾ *End (Maturity)*
This needs to be in synch with the investment horizon of the investor.

¾ *Cost*
There has to be a balance between the cost and the prospective returns, and the risk underlying those returns.

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[1] Sundar is a researcher, and best-selling author of *Indian Mutual Funds Handbook* (Vision Books:2012, 3rd edition) and *Wealth Engine: Indian Financial Planning & Wealth Management Handbook* (Vision Books:2012). He can be reached at sundar@advantage-india.in. This article is based on his book, *Wealth Engine*.

¾ *Tax Exemption*
The effective return goes up, if the investment offers a tax rebate, or if the income from that investment is tax-free.

¾ *Insurance level*
Unit-linked insurance plans, for instance, offer insurance as part of the product structure.

¾ *Vehicle*
The structure through which investment is being made, e.g. Direct, Mutual Fund, Insurance, Private Equity Fund, Venture Capital Fund, Structured Product, etc.

¾ *Valuation*
In the case of market-based products such as equities, the investor needs to consider some benchmark of valuation such as Price-Earnings Ratio or Price to Book Value Ratio.

¾ *Exchange Rate*
In the case of foreign currency denominated investments, strength or weakness of the currency is a key factor.

¾ *Leverage (asset class)*
Leveraged instruments such as futures are more risky than the plain vanilla instruments.

¾ *Leverage (foreign currency)*
Some product structures provide for returns that are a multiple or fraction of how a foreign currency has changed in value.

¾ *Yield*
The actual yield will be known only when the investor sells the product he bought earlier. But while investing, investor should have an idea of what to expect for the risks captured in the factors mentioned earlier.

Every feature of a financial product defines the exposure to a kind of risk. An investor may be exposed to the same risk through multiple types of products. For example, real estate exposure through equity, debt and direct investment.

An approach to risk management is to assess and reduce concentration of risks in the portfolio. With SSELECTIVVELLY-Invest classification scheme, it is possible to aggregate easily, all the exposures, where an attribute meets a specific criterion. For example, Sector = “Real Estate”.

Professional investors have policies that stipulate the permitted investments. For instance, credit rating not below “AA”. The SSELECTIVVELLY-Invest classification scheme enables a sharper portfolio policy for such investors.

Various attributes of a financial product are appropriate / inappropriate for different investors, depending on their risk profile. Unfortunately, mis-selling is widely prevalent in the industry — a challenge that regulators are grappling with. Regulatory restrictions on products can be based on SSELECTIVVELLY-Invest classification scheme.

A set of customised rules can be developed on product suitability for investors, based on the SSELECTIVVELLY-Invest classification scheme. Application of these rules can be left to the computer system. Even advisers who are challenged in understanding financial products will find it easy to match investment products to investors, based on their SSELECTIVVELLY-Invest classification.

Regulators can insist that all financial products sold (especially in the retail market) should feature the SSELECTIVVELLY-Invest classification attributes. This will ensure comprehensiveness of disclosure to investors — an effective antidote to sellers’ “bikini presentations” that reveal enough to tempt, but cover the vital.

The SSELECTIVY Sub-set

I codified the SSELECTIVVELLY-Invest classification system keeping in mind the product complexities that exist in the market. Therefore, it can capture a diverse range of product structures (direct investment to mutual funds to other funds to small savings schemes) and asset classes (debt, equity, gold, real estate, etc.), both domestic and foreign.

Many investors invest in simple products (as they should), for which the 14-factor SSELECTIVVELLY-Invest classification system becomes an over-kill. Simple products can be easily handled through a sub-set of the SSELECTIVVELLY-Invest Classification System. The 10-factor SSELECTIVY variant has the following attributes:

- Source (Issuer)
- Sector
- Exposure (Asset Class)
- Liquidity
- End (Maturity)
- Cost
- Tax Exemption
- Insurance level
- Vehicle
- Yield

SSELECTIVVELLY-Invest classification system for investment products and its SSELECTIVY variant are hopefully the first steps towards making better sense of investment products in a structured manner, amidst all the innovation and creativity that is cooked in the financial market.