

**CENTRE FOR FINANCIAL MANAGEMENT**

# **CFM QUARTERLY IN FINANCE**

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**EDITOR: DR. PRASANNA CHANDRA**

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**ARTICLES /CASES**

# 1. SOCIAL IMPACT ASSESSMENT

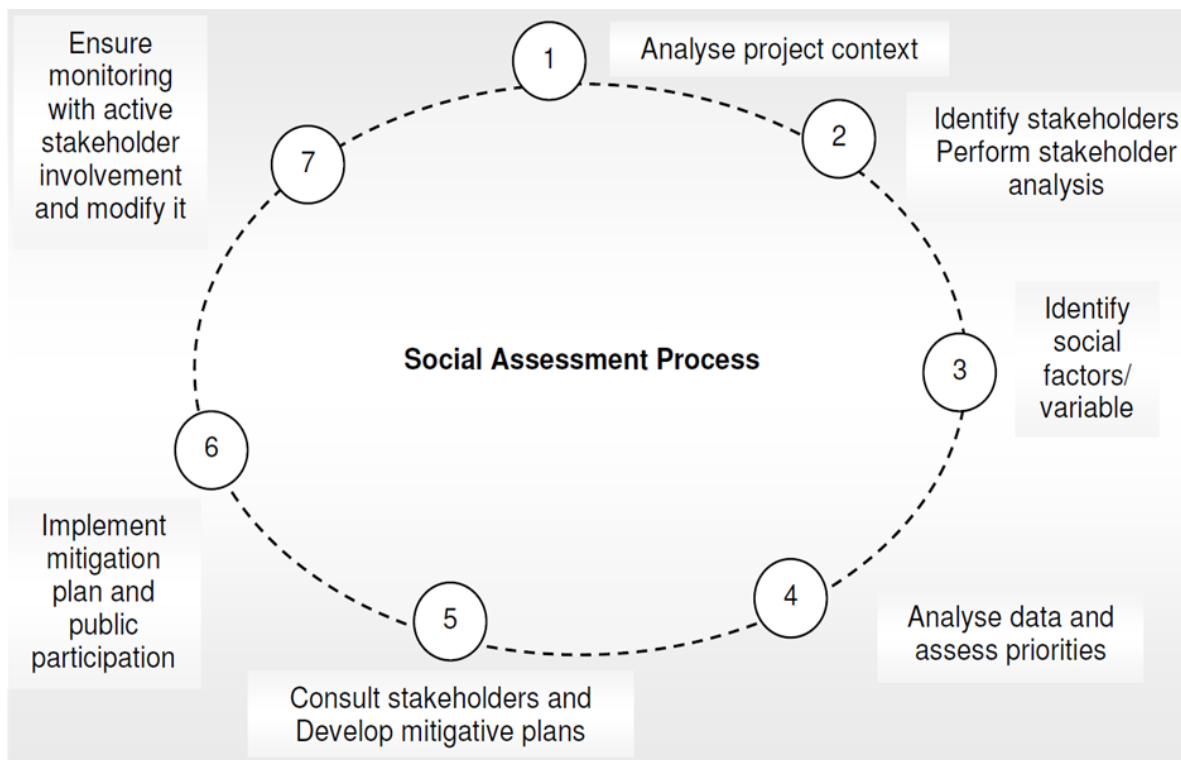
## Venugopal Unni and Prasanna Chandra

Projects have economic impacts, environmental impacts, social impacts, and biodiversity impacts. Since sustainable development is increasingly accepted as a fundamental objective for public policy and decision-making all these impacts need to be considered.

Social impacts are defined as “the consequences to human populations of any public or private actions that alter the ways in which people live, work, play, relate to one another, organize to meet their needs, and generally cope as members of society.” The main types of social impacts can be grouped into five overlapping categories : lifecycle impacts, cultural impacts, community impacts, quality of life impacts, and health impacts.

Social Assessment or Social Impact Assessment (SIA) provides a framework for considering the key relevant social aspects, involving the participation of a wide range of stakeholders, and formulating and implementing mitigative measures. Exhibit 1 provides an overview of the social assessment process cycle.

### Exhibit 1 Social Assessment Process Cycle (Adapted from Rietberg – McCracken and Narayan 1998)



### Key Principles of Social Impact Assessment

The key principles of Social Impact Assessment are as follows:

1. Achieve extensive understanding of local and regional settings to be affected by the action or policy.
2. Focus on key social and cultural issues related to the action or policy from the community and stakeholder profiles.
3. Identify research methods, assumptions and significance that are holistic, transparent and replicable.
4. Provide quality information that prescribe to scientific norms for use in decision- making.
5. Ensure that any environmental justice issues are fully described and analysed by taking into consideration the vulnerable stakeholders and populations
6. Undertake evaluation/ monitoring and mitigation measures

### **Important Aspects of Social Impact Analysis**

For meaningful SIA, the following are important:

**Public Participation** The population group that would be affected beneficially or adversely by the project should be involved in the planning process.

**Identification of Various Data Requirements** The data requirements for the proposed action need to be identified. For a road project, for instance, the data would be the location, land requirement, ancillary facilities, construction schedule, size of the work force and its local content, institutional resources and social issues like poverty, age, ethnicity, gender etc.

**Profile of Baseline Condition** The existing human environment and social conditions need to be documented. The human environment should cover gender, number of single headed households, family size, occupation, income and asset levels, education, access to health services, etc. Social issues should include population details, factors affecting income and productivity such as risk aversion of the poorest groups, land tenure, access to productive inputs, markets, labour opportunities and migration, family composition, kinship reciprocity, organization and capacity affecting participation in local level institutions and access to services and information, stakeholder attitudes and values towards the project, capacity to manage the project, and the incentives needed etc.

**Scoping of Impacts** This involves identification and prioritisation of the range of likely social impacts by reviewing all of the available social science literature, public surveys and public participation techniques etc. Social analysis and participation methods include: (a) Stakeholder workshops with a trained facilitator to assess issues and design development projects collaboratively. (b) Field visits to local

stakeholders and using participatory assessment methodologies such as participatory rural appraisal (PRA) or Beneficiary Assessment which provide tools for collaborating with local people in analysis and planning.

***Analysis and Prediction of Social Impacts*** To analyse and predict social impacts the following methods are used.

- *Comparative method* This method relies on past research and experiences in similar cases.
- *Straight -line trend projection* This method assumes that what has happened in the past will continue in the future. For example, the visitors coming for recreation will increase at the same rate as they did in the past.
- *Population multiplier methods* This method assumes that increase in population implies a commensurate increase in jobs, housing units, infrastructure needs, and so on.
- *Statistical significance means:* This involves employing statistical techniques to determine whether there is a significant difference in appropriate SIA variables with and without the proposed action.
- *Scenarios* The impact of a project on various SIA variables may be assessed by developing alternative scenarios. Experts, local authorities, and knowledgeable citizens may be contacted to create scenarios.
- *Calculation of 'future foregone'* When a social assessment is done, it is important to ask: What options would be given up irrevocably as a result of the project? For example, the construction of a dam will preclude river recreation and submerge agricultural land.

***Evaluation of Alternatives and Impact Modification*** It is worthwhile to evaluate, on a modest scale, alternatives or modifications to the project and their consequences for the affected parties. Also, a mitigation plan needs to be developed and implemented, in order of preference, to avoid, minimise and compensate for the adverse impacts. This could be done by modification or redesign of the project/policy or compensation through substitute facilities, resources and opportunities.

***Monitoring Plan*** A monitoring plan should be implemented, by tracking and comparing, to identify deviations from the proposed plan and any important unanticipated impacts. It should spell out, to the degree possible, the nature and extent of additional steps needed in such events.

***Biases*** SIA practitioners should guard against the following biases:

- *Spatial bias* Information may be gathered from accessible locations, overlooking remote areas or nomadic tribes.
- *Seasonal bias* SIA may be carried out at a time (such as harvesting time or hunting season) when it may be difficult to gain representative information.
- *Personal bias* Information may be gathered from influential people only.
- *Professional bias* There may be an inadequate interaction between disciplinary specialists, resulting in omission of important linkages.

\*Source: *Impact Assessment and Project Appraisal*, Volume 21, Number 3, September 2003.

## **2. SALIENT DIFFERENCES BETWEEN THE APPRAISAL OF CAPITAL INVESTMENT PROJECTS AND INFRASTRUCTURE PROJECTS**

**Vivek Date**

For the purpose of this note, projects may be classified as follows:

- A. A capital investment project set up within an existing company.
- B. A capital investment project set up as a separate company which is a subsidiary or associate of an existing company (parent company)
- C. An infrastructure project set up as a special purpose vehicle (a separate company) by sponsoring companies.

The manner in which these projects are appraised by the investors and lending institutions is shown below.

	A. Capital Investment Projects Within Existing Company.	B. Capital Investment Project Set up as a Separate Company.	C. Infrastructure Project Set Up as a Special Purpose Vehicle (Separate Company).
Appraisal by the Investors			
Cash Flows	<ul style="list-style-type: none"> <li>• Cash flows are defined as incremental project cash flows.</li> </ul>	<ul style="list-style-type: none"> <li>• Cash flows are identified from the point of the separate entity.</li> </ul>	<ul style="list-style-type: none"> <li>• Project cash flows as well as equity cash flows are considered.</li> </ul>
	<ul style="list-style-type: none"> <li>• Cash flows are generally considered for a period of 10 years or the loan repayment period.</li> </ul>	<ul style="list-style-type: none"> <li>• Cash flows are generally considered for a period of 10 years or the loan repayment period.</li> </ul>	<ul style="list-style-type: none"> <li>• Cash flows are considered for the entire project life or 30 years whichever is lesser.</li> </ul>
	<ul style="list-style-type: none"> <li>• There is usually a salvage value which is positive</li> </ul>	<ul style="list-style-type: none"> <li>• Since the new entity is regarded by the parent as a 'going concern' with indefinite life, no salvage value is considered.</li> </ul>	<ul style="list-style-type: none"> <li>• There may or may not be any salvage value. Sometimes, there may be outlays incurred for dismantling or winding up the project.</li> </ul>

Appraisal Criteria	<ul style="list-style-type: none"> <li>The commonly used appraisal criteria are NPV, IRR, payback period, and accounting rate of return.</li> </ul>	<ul style="list-style-type: none"> <li>Considering the indefinite life of the business entity the parent company may use accounting rates of return such as ROE and ROI.</li> </ul>	<ul style="list-style-type: none"> <li>NPV and IRR are calculated from the project point of view (PNPV and PIRR) and the equity point of view (ENPV and EIRR).</li> </ul>
	<ul style="list-style-type: none"> <li>A shorter payback period is used because firms do not want to take risk of uncertainties in volume of sales, competition, input costs, and so on.</li> </ul>	<ul style="list-style-type: none"> <li>A little longer payback period is used depending upon the magnitude of investment and the nature of business.</li> </ul>	<ul style="list-style-type: none"> <li>An even longer payback period is acceptable because the outputs of services have an assured take off and competition is restricted.</li> </ul>
Benchmark Rate	<ul style="list-style-type: none"> <li>Weighted average cost of capital (WACC) is the most commonly used discounted rate for calculating the NPV or evaluating the IRR.</li> </ul>	<ul style="list-style-type: none"> <li>A risk – adjusted return on equity (ROE) is generally used for assessing the new entity.</li> </ul>	<ul style="list-style-type: none"> <li>Weighted average cost of capital (WACC) is used to calculate PNPV and judge the PIRR. Cost of equity is used to calculate EPNV and judge the EIRR.</li> </ul>
<b>Appraisal and Requirements of Lending Institutions</b>			
Debt Service Coverage ratio	<ul style="list-style-type: none"> <li>A debt service coverage ratio of 1.5 is required.</li> </ul>	<ul style="list-style-type: none"> <li>A debt service coverage ratio of 1.5 is required.</li> </ul>	<ul style="list-style-type: none"> <li>A slightly lower debt service coverage ratio of 1.35 is acceptable.</li> </ul>
Recourse	<ul style="list-style-type: none"> <li>Entire company cash flows are relevant even though only incremental cash flows are considered for calculating NPV and IRR.</li> </ul>	<ul style="list-style-type: none"> <li>Cash flows of the new entity only are relevant. Sometimes guarantees are sought from the sponsors.</li> </ul>	<ul style="list-style-type: none"> <li>Cash flows of the SPV only are relevant, as loans are typically non-recourse based.</li> </ul>
Loan Security/	<ul style="list-style-type: none"> <li>Primary and collateral</li> </ul>	<ul style="list-style-type: none"> <li>Over and above the</li> </ul>	<ul style="list-style-type: none"> <li>Movable assets are</li> </ul>

Guarantee	security from the company are insisted upon.	primary and collateral securities, guarantees from promoters are insisted upon.	hypothecated. In addition, escrow accounts, assignment of all contracts, pledge of shares of sponsors, and step-in agreement are insisted.
Lenders' Control	<ul style="list-style-type: none"> <li>Lenders are not much concerned with the agreements between the company and its buyers and suppliers.</li> </ul>	<ul style="list-style-type: none"> <li>Lenders are not much concerned with the agreements between the company and its buyers and suppliers.</li> </ul>	<ul style="list-style-type: none"> <li>Lenders examine the agreements between the SPV and all the contracting parties.</li> </ul>



### 3. THE SUCCESSFUL INVESTOR TODAY

**Prasanna Chandra**

Larry E. Swedroe's *The Successful Investor Today* (Published by St. Martin's Griffin in 2003) discusses the implications of modern investment research for successful investing. The key insights explored in the book are as follows:

1. Active investing is a Loser's game.
2. Actively managed funds lack consistency in performance.
3. The interests of financial services industry are not aligned with those of investors.
4. The price you pay matters.
5. Investors do not diversify adequately.
6. There is an information paradox.
7. Macroeconomic forecasts lack reliability.
8. Investors need a very long investment horizon.
9. The allocation to equity depends on the ability, willingness, and the need to take risk.
10. Fixed income investors should avoid long- term instruments.

**1. Active Investing Is a Loser's Game** To understand why active investing is a Loser's game, let A present all investors, B represent active investors, and C represent passive investors. B and C account for say, 60 per cent and 40 per cent of the market. If the market rate of return is 15 per cent, the rate of return earned by passive investors will also be 15 per cent. This means that collectively the active investors will also earn a gross return of 15 per cent. If one active investors outperforms because he was overweight on the top-performing stock, another active investor underperforms because he is underweight on the top- performing stock. After deducting the trading costs, active investors as a group will underperform the market. This is the import of the statement, "Active investing is a Loser's game."

Yet millions of investors try to outperform the market through active investing. This has puzzled Nobel Laureate Daniel Kahneman. As he put it : "What's really quite remarkable in the investment world is that people are playing a game which, in some sense, cannot be played. There are so many people out there in the market; the idea that any single individual without extra information or extra market power can beat the market is extraordinarily unlikely. Yet the market is full of people who think they can do it and full of other people who believe them. This is one of the great mysteries of finance: Why do people believe they can do the impossible? And why do other people believe them?"

**2. Actively Managed Firms Lack Consistency in Performance** There is no consistency in the performance of actively managed equity funds. Their past performance is a poor guide to future performance. So the search for top-performing equity funds is somewhat futile. As Jonathan Clemens said: "I believe the financial columnist's search for top performing stock funds is an intellectually discredited exercise that will come to be viewed as one of the great follies of the late 20<sup>th</sup> century." In a similar vein, John Reckenthaler, research director for Morningstar put it: ".. to be fair, I don't think you'd pay much attention to Morningstar's star ratings either."

**3. The Interests of Financial Services Industry Are not Aligned with Those of Investors** The interests of Wall Street and the financial media are not in line with the interests of investors. Here are some insights presented by financial reporter Patrick Regnier of MONEY magazine.

- Financial publications overhype some managers while dismally underestimating others. They seem to peddle hype and hope, not valuable insights.
- Star performers of the past are likely to be today's laggards.
- The skill of a manager matters less than the trend he is riding or failing to ride.

Of course, as in any other profession, there are conscientious people in financial media such as Jason Zweig, Jonathan Clements, Jane Bryant and others who have the interests of investors at heart. When he was on his death bed Zweig's father, also a journalist, told him: "You can make money in this world by lying, or by telling the truth. In the short run you can make a little money by lying to people who want to hear the truth, or a lot of money by lying to people who want to be lied to. But you can't ever make any money by telling the truth to people who want to be lied to. In the long run, you make the most money by telling the truth to people who want to hear the truth."

However, a large group of investors want to be lied to. They nurture the belief that they can discover the next Microsoft and the media delivers what they want.

**4. The Price You Pay Matters** Most investors do not understand the math of investing. They naively extrapolate past returns into the future. Bull markets (bear markets) lead investors to expect higher (lower) returns in future. The reality is that as the prices rise, the expected future returns fall and vice versa.

**5. Investors Do Not Diversify Adequately** William Goetzmann and Alok Kumar examined over 40,000 equity investment accounts at a large discount brokerage firm during the six- year period 1991-1996. They found that a vast majority of investors held undiversified portfolios the average investors held a portfolio of just four stocks and less than 5 per cent of investors held 10 stocks or more.

Failure to diversify may be because of lack of knowledge and human behavioural traits. Most investors do not understand the benefits of diversification or are confident of their investment skills or falsely believe that by limiting the number of stocks they hold they can manage their risks better.

**6. There is an Information Paradox** When you listen to or read an analyst or fund manager explaining why you should invest in a specific stock or sector bear in mind the *information paradox*. While you may be impressed by his intellectual capacity as well as the rationale for his recommendation, bear in mind the following points before you swing into action.(i) If you get the advice on a television show, it is already in the public domain. (ii) The market is quite competitive and information ally efficient. (iii) The fund manager may tout a stock that he already owns but wants to sell.

**7. Macroeconomic Forecasts Lack Reliability** William Sherdeen, author of the best selling book *Fortune Sellers*, reviewed the leading research on the accuracy of forecasts made from 1970 to 1995. He found that.

- Economists cannot forecast the turning points in the economy.
- The forecasting skills of economists is about as good as guessing.
- No economic forecaster consistently leads the pack in forecasting accuracy.
- Forecasting accuracy does not improve with increased sophistication.
- Consensus forecasts do not lead to improvement in accuracy.
- Psychological biases affect forecast. Some economists are chronically optimistic and others chronically pessimistic.

Sherdeen's findings have in a way been echoed by Paul Samuelson, a Nobel Laureate in Economics and Michael Evans, founder of Chase Econometrics. Paul Samuelson commented: "I don't believe we're converging on ever-improving forecasting accuracy. It is almost as if there is a Heisenberg (uncertainty) Principle." Michael Evans said: "The problem with macro (economic) forecasting is than no one can do it."

Given the futility of economic forecasting, intelligent economists refrain from it. As Swedroe put it, "Economists, if they are smart, learn to never

forecast. If they have to make a forecast, they learn to never give a number. And if they have to give a number, they never give a date. In that way they can never be proven wrong.”

- 8. Investors Need a Very Long Investment Horizon** No asset class performs with consistency. History shows that every asset class does very poorly for long stretches of time. So, to avoid some serious investment mistakes you should have a very long investment horizon- longer than most investors would believe, let alone what the vast majority of investors will have the discipline to stay the course. As Swedroe said: “It is my experience that despite what investors will tell you, their typical investment horizon is three years or less (and you will see data to support my experience).It seems that just a few short years is all investors have the patience and discipline for.”
- 9. The Allocation to Equity Depends on the Ability, Willingness, and Need to Take Risk** The allocation to equity is a function of the ability, willingness, and need to take risk, as shown in the following Exhibit 1,2, and 3. This are Swedroe’s recommendations for the U.S. environment.

**Exhibit 1 Ability to Take Risk**

<i>Investment Horizon (Years)</i>	<i>Maximum Equity Allocation (%)</i>
0-3	0
4	10
..	
10	70
11-14	80
15-19	90
≥20	100

### **Exhibit 2 Willingness to Take Risk**

<i>Maximum Tolerable Loss</i>	<i>Maximum Equity Exposure</i>
5	20%
10	30%
..	
40	90%
50	100%

### **Exhibit 3 Need to Take Risk**

<i>Finacial Goal ( Required Rate of Return, %)</i>	<i>Equity Allocation</i>
2	0
3	20
4.5	40
6.0	60
7.5	80
9.0	100

**10.Fixed Income Investors Should Avoid Long- Term Instruments** Academic research has found that over long periods of time investors are compensated for accepting the risk of owning fixed income instruments of longer maturity. However, this relationship seems to break down beyond three to five years. So extending the maturity beyond this period hurts. So, a fixed income investor seeking the highest expected return over a 30- year period should buy a three year bond and continually roll it over, instead of buying a 30- year bond.

## B. SNIPPETS

### 1. THE EASTERLIN PARADOX

While richer nations and households are happier compared to poorer nations and households increase over time in per capita income in the industrialised nations have not resulted in greater happiness. For example, between 1958 and 1987, Japan's per capita GDP increased fivefold but its happiness level hardly changed. This puzzle is called the "Easterlin Paradox."

What explains this paradox? Three interrelated explanations have been offered: genes, habituation, and social comparisons.

**Genes** One theory is that we are born with a "set point" for happiness and our happiness fluctuates around that point.

**Habituation** Over time, we become "habituated" or accustomed to most things and hence they are not as pleasurable as they were in the beginning. Further, people tend to overestimate the pleasure they would derive from owning material goods. Psychologists call it the "impact bias." There is an adage about the two happiest days in a boat owner's life- the day of purchase and the day of sales.

**Social Comparisons** Given their competitive nature, people judge how well they are doing by comparing themselves with some "reference group." Ambrose Bierce defined happiness as. "an agreeable sensation arising from contemplating the misery of another."

### 2. CARDINAL SINS IN TESTING MARKET EFFICIENCY

According to Aswath Damodaran there are several pitfalls in testing for market efficiency. They are as follows:

1. Anecdotal evidence is used to support or reject an investment strategy. Given the noisiness of stock prices, almost every scheme, irrespective of how absurd it is, will work on some occasions. Such evidence can't be the basis for testing market efficiency.
2. A strategy is tested using the same data and time period from which it was extracted.
3. The sample on which the test is run is biased.
4. The overall market performance may not be considered.
5. The risk factor may not be considered.
6. Correlation may be mistaken for causation.

### **3. THE SECOND BIG SHIFT**

Up until the late 1950s, in the U.S the dividend yield on equities was more than the yield on government bonds. This is because equities were perceived to be more risky than bonds, particularly after the collapse of equity prices during the Great Depression.

But from the mid – 1950s onwards, as the memories of the Depression faded equities were considered favourably. It was realised that while individual stocks might be risky, a diversified portfolio was much more secure. The dividend income from equity shares would rise over time while bond income remained fixed. As inflation soared in the 1960s and 1970s, bonds lost their attraction. The “cult of equity” had arrived and dividend yield on equities fell below bond yield.

Since 2008, however, the developed world has been struggling to produce consistent growth and generate inflation. Both these factors favour bonds rather than stocks. Hence dividend yield has risen above bond yield after several decades.

### **4. WHY ARE HUMANS BAD AT REASONING**

In their celebrated article “Why Do Humans Reason? Arguments for an Argumentative Theory,” Hugo Mercier and Dan Sperber asked why are humans so amazingly bad at reasoning in some contexts, and so amazingly good in other contexts. The answer, according to Mercier and Sperber, is that reasoning was designed by evolution to help us win arguments and not pursue the truth. As they put it, “The evidence here shows not only that reasoning falls quite short of reliably delivering rational beliefs and rational decisions. It may even be, in a variety of cases, detrimental to rationality. Reasoning can lead to poor outcomes, not because humans are bad at it, but because they systematically strive for arguments that justify their beliefs or their actions. This explains the confirmation bias, motivated reasoning, and reason- based choice, among other things.”

## **PART C: WIT AND WISDOM**

### **1.HUMOUR**

- A man accompanied by a small boy went to a barber’s shop. After his haircut, he told the barber that he was going to a beer shop nearby and asked the barber to cut the boy’s hairs in the meanwhile. He did not return. The barber cut the boy’s hairs and asked the boy where is your father. The boy said: “I don’t know that man. He only wanted to know whether I wanted a free haircut.”
- After a musical show, when the quitting whistle was blown, Murphy shouted, “Has anyone seen my coat.” The usher said, “Sure sir, and you’ve got it on.”

Murphy replied, "It is a good thing you have seen it- otherwise, I would have gone home without it."

## **2. WISE SAWS**

- Integrity is telling myself the truth. And honesty is telling the truth to other people.

Spencer Johnson

- There is no security on this earth there is only opportunity.

Douglas Mac Arthur