Dimensions of Personal Finance and Investment: An overview

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Personal Financial Planning

The domestic and work related responsibilities of most investors do not permit them to go deep into the intricacies of investment, insurance, finance, real estate and taxation. Common investors require investment advice that is simple, effective, easily understood and easily remembered. Few sectors are witnessing such explosive growth as the financial services sector. There is a crying need for properly trained financial advisors in India today.

Unfortunately, there is a tremendous dearth of such advisors. Most so-called advisors are nothing but agents who in collusion with the corporations represent or work for, generate and use a lot of hype to aggressively sell financial products and services to gullible investors and customers, whether or not such products and services are advisable for them. As a result, experiences of the common investors in investment, insurance, real estate etc., have been far from pleasant. The disaster stories how investors have lost tons of money in imprudent financial adventures are too numerous and well known to be recounted here.

Personal Financial Planning is the conceptualisation and implementation of a comprehensive financial plan for the achievement of a person's total financial objectives.

The areas covered by a normal Personal Financial Plan are:

1. Insurance

1.1 Health Insurance should be compulsorily taken. The entire family must be covered by health insurance. It is advisable to choose family floater policies which cover at least four members of a nuclear family, with any one person entitled to make use of the entire cover,

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should the need arise. 'Personal accident' and 'critical illness' riders may be taken if necessary.

1.2 Personal Accident Insurance should be taken only by earning members of the family to cover the risk of partial and permanent disability.

1.3 Critical Illness Insurance should be taken for all the family members to cover the risk against costly treatment of terminal deceases.

1.4 Life Insurance: If an individual has no financial dependents, life insurance is not necessary and will be a waste of money. If there are financial dependents, the quantum of life cover required must be calculated. Thereafter, it is advisable to take only a pure term life insurance cover, to the extent life insurance is required.

1.5 Property Insurance: Protection against losses caused by earthquake, fire, damage from other causes, breakdown, burglary, etc., may be taken if required, and to the extent required.

1.6 House Hold Insurance to cover the risk of fire and burglary of electronic goods, furniture, interiors, etc., may be taken if required, and to the extent required.

2. Emergency Funding

Ensure that an amount equal to at least 12 months' normal living expenses is deployed in highly liquid avenues like money market accounts (called 'liquid funds' in India), short-term mutual funds, short-term floating rate mutual funds, 'flexi' bank deposits, etc.

This builds an excellent buffer in case of unexpected shocks like job/earnings loss, change of residential status, migration to a different country, unforeseen but necessary expenditure, etc.

Investment in any short-term debt fund with monthly or quarterly capital appreciation transfers to an equity index fund or diversified equity fund would be an excellent strategy for an emergency fund. An emergency fund is your private insurance policy and your first line of defence when tackling an unexpected, adverse financial situation.

It is important that an emergency fund be utilised only in an emergency.
3. Retirement Planning

Never expect either the government or your employer to provide for your retirement. You are responsible for your financially comfortable retirement. No one else is. There is a wrong notion that planning for retirement should start when a person approaches retirement. Nothing can be farther from the truth. Retirement planning must start as soon as a person starts earning. As the old Chinese proverb states, do not wait until you are thirsty, to dig a well.

The best “private” retirement plan would be a sustained systematic investment into a well-diversified portfolio of blue chip stocks, diversified equity mutual funds, equity index funds, and, resources permitting, real estate.

So long as interest on the Public Provident Fund (PPF) remains tax-free, this would also be an excellent retirement avenue for the conservative investor. Employees, who are eligible for the Employees' Provident Fund (EPF) benefit, should make contributions to the EPF at least to the extent of matching contributions by the employer.

From the financial year 2014-15 onwards, Section 80C of the Income-Tax Act, 1961, has provided an excellent opportunity to build a tax-advantaged retirement fund up to Rs 1.5 lakhs per financial year (presently), using among other avenues, PPF and 'equity linked savings schemes (ELSS)' of mutual funds.

While the exemption under Section 80C may be a sweetener, it should be borne in mind that a retirement fund is of vital importance in its own right, whether or not there is a tax benefit attached to it.

Just as an emergency fund must be used only in an emergency, withdrawals from a retirement fund must be contemplated only upon retirement. The solitary exception to this rule is if the family or any of its members is threatened with a life-and-death situation, and emergency funds and insurance have already been exhausted.

4. Housing

Everyone must aspire to owning a dwelling. This is the only area where no one will object to a loan being taken for acquiring an
apartment or house. Today, housing loans are freely available and there are substantial tax advantages attached to the repayment of principal and the payment of interest on these loans. However, it should be remembered that the acquisition of a residential house is important in its own right, regardless of any tax advantage attached to it.

If the individual has need for commercial premises for his own use such as an office, shop or showroom, steps may be taken over time to acquire the ownership of such premises. Additional real estate investments may be undertaken only if the individual has specialized knowledge and a keen interest in real estate investments.

5. Extinguishing Debt

It would be very prudent to have no debt at all, except perhaps a housing loan, if needed. Get rid of dangerous, high cost, open-ended debt like credit card debt, personal loans, cash credits and overdrafts. Use only term loans, that too sparingly, and only for the acquisition of vitally important productive assets such as a residential house or truly useful higher education.

6. Investment

Investment can be for parking funds, to earn regular returns and for growth. Use savings accounts, 'flexi' accounts, liquid, short-term floating rate mutual funds for short duration parking of funds. Use Post Office Monthly Income Scheme, Taxable Government of India Savings Bonds, Senior Citizens' Savings Scheme (for persons of 60 years and above only), bank fixed deposits, short and long-term floating rate mutual funds, fixed maturity plans of mutual funds, and structured withdrawals from PPF accounts, to earn regular returns.

Invest in a very well diversified equity portfolio of blue chip stocks and/or use systematic investment and systematic transfer plans into mainline diversified equity mutual funds, for wealth enhancing (growth) investments. Real estate is also a good, long-term, wealth-enhancing avenue of investment.

However, real estate suffers from some drawbacks such as poor liquidity, difficulties in verification of title, requirement of large
amounts of capital for a single purchase, high registration costs, menace of black money in real estate transactions, problems arising out of absentee landlordism, etc.

Real estate mutual funds should be available in India before long, at which time systematic investment and systematic transfer plans into these funds can certainly be considered.

7. Other Objectives

Vehicle purchases, children's education, marriages and family functions, family vacations, down payment on real estate purchase, renovation of real estate assets, etc., can be provided for by setting up a general investment fund, following a simple asset allocation plan. When in doubt, maintain a 50:50 balance between debt and equity in this account, and rebalance it at annual intervals.

Do not neglect succession and estate planning. Prepare a will.

Ensure that all bank accounts and investments are either in joint names or with nominations registered.

Ensure that the spouse and/or family are kept aware of investments, insurance policies, retirement benefits, tax matters, etc.

Regularly review investments. Make changes only when required. Do not constantly tinker with investments.

Ensure that all adult family members apply for and obtain an income-tax PAN card, an election identity card, a passport, a driving license and (if necessary) an Aadhaar card.

Know your client (KYC) registration formalities for mutual fund investments may be undertaken and completed. The opening of client and demat accounts with a member of a recognised stock exchange and depository participant respectively may also be completed, if direct equity investment is contemplated.
Mutual Fund Investment

Some of the investment options in mutual funds are briefly described below. Depending upon your risk appetite, you can choose the option/s you are comfortable with.

Option 1: Debt Mutual Funds

For investments of uncertain duration and investments of up to 3 months' duration, money market accounts and liquid plans of mutual funds are excellent investments. They would be attractive alternatives to savings accounts of banks, without compromising on either liquidity or safety. For investment horizons of more than 3 months and less than a year, 'liquid plus' plans and short-term floating rate mutual funds (also called 'floaters') offer liquid investment avenues with a high degree of safety.

If the period of investment exceeds a year, the best options would be short-term funds. For time horizons of more than 3 years, Fixed Maturity Plans (FMPs) would be ideal. FMPs of over 3 years are more tax-efficient than comparable cumulative bank fixed deposits, especially for investors in the higher tax brackets. Let us explain.

If any of the categories of debt funds mentioned above is liquidated after three years, the resulting appreciation will be taxed at the long-term capital gains tax rate of (presently) 20.6 percent with cost inflation indexation. To that extent, these funds are tax-efficient, especially for investors in the higher income-tax brackets of 20.6 percent and 30.9 percent.

An important feature of floating rate funds is that in the event of a rise in the general interest rates, the returns on these funds will also rise automatically, because they basically invest in floating rate securities. A fall in general interest rates will result in lower yields from floaters. Short-term floaters are very liquid.

On the other hand, short-term funds will do better when interest rates fall and worse when interest rates rise. A mix of liquid funds and floaters on the one hand, and short-term funds on the other, could be a good way of parking funds or investing for short and intermediate time horizons.

Dividends on all mutual funds are tax-free. However, for investments
of more than three years, the growth option is better, because non-equity mutual fund plans, including debt fund plans have to deduct a dividend distribution tax in case of dividends paid out or reinvested, which is presently higher than the long-term capital gains tax payable on growth options.

NRIs can invest in debt funds both on a repatriable and non-repatriable basis. Investment in these funds carries low risk, provided an investor exercises some caution and diversification in the choice of funds.

**Option 2: Debt Mutual Fund to Diversified Equity Mutual Fund Systematic Transfer Plan**

This strategy requires a minimum investment of Rs 50,000/-, even though starting with Rs 1,00,000/- is better. The strategy can best be understood by the example of how a basic investment of Rs 1,00,000/- would be made. This initial corpus is placed in a liquid or short-term or short-term floating rate fund. From here, 2 percent of the principal (Rs 2,000/- for a Rs 1,00,000/- lump sum) is systematically transferred to a diversified equity fund.

Our experience with this type of investment for investors in India shows that attractive and tax-efficient returns can be earned in a period of five years or more, with relatively low risk to principal. Invest in this strategy only if you are reasonably confident that you do not need to withdraw funds for at least five years.

**Option 3: Highly Conservative Systematic Transfer Plans**

Here the objective is to preserve the principal invested even in a bad stock market. The simplest way to do this is to invest the lump sum in a liquid or liquid plus or short-term floating rate or short-term fund and then register a monthly or quarterly transfer of only the capital appreciation to an index fund or diversified equity fund. This is the closest you can come to fashioning a zero-risk mutual fund strategy on your own, allocating assets between debt and equity.

You could also try a variation of Option 2. Instead of two percent, only one percent of the principal is transferred every month from the debt fund to the equity fund in this strategy. The minimum investment advised here is Rs 1,00,000/-. We have not seen a risk to
capital in this strategy even during the global financial crisis that started in the latter half of 2007. That does not mean risk cannot occur. There is no such thing as a risk-free strategy. But the probability of a risk to principal here is remote.

There can be value additions to the above strategies. After you have begun any of the two investment strategies mentioned in the two paragraphs appearing immediately above this one, if the stock market index falls by at least 25 percent from its last peak and remains at this lower level for at least a month, you would do well to double the monthly systematic transfer of Rs 1,000/- to Rs 2,000/-. Similarly, in case the index falls by 50 percent from its last peak, we would recommend transferring the entire balance in the debt fund to the equity fund/s.

These strategies are recommended for investors who wouldn't mind an exposure to the stock market, but want to be shielded from the risks associated with equity investment. These strategies are also ideal for investors with no previous experience in stock market investment.

Investors who opt for this would be following Warren Buffett's famous dictum: “The first rule of investing is, do not lose. And the second rule is, do not forget the first rule. And that's all the rules there are.”

**Option 4: For regular fund flows – Systematic Investment Plans (SIPs)**

SIPs into a mix of debt, balanced, asset allocation, diversified equity, equity index and (when they are available) real estate mutual funds are probably the best way of building wealth in the long term. SIPs into any mutual funds that have an element of equity must be continued without interruption for a period of at least five years, and preferably for much longer.

**Conclusion**

The subject of investment and personal finance is very vast, hence it is very difficult to cover the concept in an article of this type. However, a tip of the iceberg is shown here. But experience is the great teacher than any advice.