FUNDAMENTALS OF INVESTING

Section 1

Why do we save?

Savings is the amount of money set aside by us, so that it can be used later. The money is set aside as reserve, instead of spending it immediately. This is done with a purpose to accumulate a fund over a period of time, so as to meet the expenditure like children education, purchase a car, house, etc. in the future, or to use it in case of an emergency. The time duration taken to achieve this goal depends on how much amount of money we can put aside as savings every year. Let us take a look at the illustration below:

Illustration 1:
Goal – To purchase a Car
Current Cost of Car – Rs. 5 Lac
Yearly Savings – Rs 50,000
Years taken to achieve the goal – 10 years

Savings form an important part of the economy of any nation. With savings invested in various investment options available to the people, the flow of money acts as the driver for growth of the economy.

However, in the above illustration, we do not earn any additional *income* on our savings, unless we decide to *invest* it in some suitable avenues.

Keeping the money with Banks

The most common practice is to keep our hard earned money with a bank whereby such savings earn interest at the prevailing rate, which helps our money grow.

Illustration 2:
Goal – To purchase a Car
Current Cost – Rs. 5 Lacs
Yearly Savings – Rs. 50,000
Assumed Rate of Interest – 6 % p.a.
Years taken to achieve the goal – 8 years *

* based on simple interest at the end of each year.

Thus, we see that *investing* the money makes good sense, as it can aid us in achieving our financial goals much faster.

What Can Possibly Go Wrong?

There is a possibility that the cost of the car - which we intend to buy with our savings - can go up in the next ten years. This is due to an economic phenomenon called *inflation* (i.e. trend of rise in general level of prices of goods and services over time). The increased cost of car can therefore delay our purchase decisions or may put it off completely.

What is the solution?

We have noticed that keeping our savings with a bank can earn us interest, which can help us in meeting our financial goals faster. We have also observed that there is a real life threat of rise in prices of goods and services over time, known as inflation, which can derail our plans. In such a scenario, we need to find alternate investment avenues which are capable of combating these inflationary trends. In other words, we need to invest our savings so that our investments grow at a rate that can beat the prevailing inflation rate.

What is Investment?

Money used to purchase securities, put in a collective investment scheme or used to buy any asset where there is an element of capital risk is deemed an investment. Savings refers to money put aside, normally on a regular basis. This distinction is important, as investment risk can cause a capital loss when an investment is realized, unlike savings where the more limited risk is cash devaluing due to inflation. It is a long term activity and based on the long term goals, investment decisions may differ across investor categories depending on individual preferences. Investing means to have a financial plan in place and buy assets that will be profitable over the long run.

Section 2

Why invest at all?

The basic premise for starting a detailed investment process is to allow our money to grow, as opposed to it lying idle with us. This is because the real value of the money in future may not be equal to the value at present, due to inflation.

With the increasing consumerism trends, our aspirations are also rising. Therefore, investments aimed at just beating inflation will not help us achieve our aspirations. Thus, other long-term reasons for starting an investment process could be to achieve financial goals like buying a car or residential house or planning for retirement. In other words, we want our money to grow to be able to attain financial freedom and meet our goals.

The followings 3 steps should be followed to build an investment plan:

- Identification of goals and the time duration required to achieve them.
- Making a regular contribution to our savings account.
- Identification of suitable investment avenue to suit our needs.

So, when do I start?

There is no ideal age or time to start investing. The earlier we begin investing, the better. A difference of few years can make a lot of difference due to a mathematical phenomenon called ‘compounding’, whereby we start earning on not only on our principal but also on the accrued earnings. (compounding refers to generating earning from previous earnings). Einstein referred to it as the “eighth wonder of the world”, and it can seem almost like magic. The money multiplier effect can make a substantial difference to our savings basket, if one starts early and leaves the invested amount untouched for a longer period. Let us see both the scenarios by way of an illustration:

Money attracts Money

If Mr. A, who starts investing at the age of 35, invests Rs. 1 Lac per annum, then at the age of 60 he would have a retirement kitty of approx Rs. 92 lakhs, assuming a conservative growth rate of 9 per cent. But, let us assume that there is Mr. B, who started investing at the age of 25. Assuming the same growth rate, the retirement kitty would have swelled to approx Rs 2.35 crores. The difference in the retirement kitty is amazing and illustrates the power of compounding. The gap gets wider if the growth rate is higher during the investment period. The following table will give us some idea:

(Rs. In Crores)

Growth Rate * (p.a.)	Retirement Kitty of Mr. A (started investing at Age of 25)	Retirement Kitty of Mr. B (started investing at Age 35)	Difference in retirement basket*
6 %	1.18	0.58	0.60
9 %	2.35	0.92	1.43
15 %	10.13	2.45	7.69

** The earnings rate in the above illustration are hypothetical and does not in any manner indicate the prevailing rate of return. Assuming the person retires at age 60*

There are two key things to be observed from the above illustration. Firstly, the age at which a person starts investing can make a lot of difference. A mere headstart of 5 – 10 years can make a lot of difference in the long run. In fact, the money multiplier effect ensures that the money grows at a very rapid pace in the later years, as an investor starts earning on not only his principal amount but also on his accrued earnings. Secondly, the rate at which our money is growing also makes a significant difference in the end. A difference in the growth rate can make a lot of difference, as can be observed from the illustration. A conservative rate of interest of 6 per cent p.a. which can be achieved through fixed income securities and an aggressive growth rate of 15 per cent p.a. which can be achieved through equity investments can make a difference of approx Rs. 8.95 crores at the time of retirement, if a person starts investing at the age of 25.

Therefore, it is not only imperative to start investing at the early age, but also necessary to select the right instrument which can generate higher growth rate during the investment tenure, keeping in mind our needs and risk appetite.

Section 3

Knowing Your Risk Appetite

Once we have defined our financial objectives and the investment duration, it is time to make the investment decisions based on our suitability. It is interesting to note that social personality traits of a person can be different from the way he behaves when it comes to taking financial decisions. For example, a person may be very aggressive in his social life, but may be very conservative in the way he manages his money. The amount of risk a person can undertake depends on a lot of factors including his age, liabilities, number of dependants etc. For example, the ability to undertake risk is more for a young executive who has just started working and has limited liabilities. In contrast, a middle aged executive in his 40s with number of dependants will be more averse to risk-taking. The risk appetite of a retired couple would be the least, as they don’t have a source of income, and for them preservation of their capital is paramount. Therefore, depending on the risk appetite, proportionate allocation to different asset classes can be decided based upon the investor’s risk appetite and needs, ranging from risky assets to relatively safer investment products.

You can find out your risk appetite and the resultant asset allocation distribution, by taking a **risk-profiling quiz here**.

Section 4

Types of asset classes

The different types of major asset classes available to Indian investors are as follows:

- Cash
- Stocks
- Bonds
- Real Estate
- Gold

Depending upon his risk profile, an investor can choose to invest in any of the above mentioned asset class - where each one has a unique risk-return tradeoff - or a combination of some or all of the asset class, to build a portfolio.

Cash

Cash and cash equivalent refers to liquid and current assets comprising of hard currency and near currency assets viz. T-Bills, commercial paper, Money Market instruments, short term government bonds, which can be converted to hard currency immediately or on a very short notice. It is an important asset class, and is also used as an effective asset allocation tool by the portfolio managers.

Stocks

Stocks refer to the shares of a company, which is a unit of ownership in the company. As you acquire more stock, your ownership stake in the company increases. Whether you say shares, equity or stock, it all means the same thing.

Holding a company's stock means that you are one of the many co-owners (shareholders) of a company and, as such, you have a claim (proportionate to your holdings) to everything the company owns. This means that technically you own a tiny sliver of every piece of furniture, every trademark, and every contract of the company. As an owner, you are entitled to your share of the company's earnings as well as any voting rights attached to the stock.

Stocks are generally more risky and there is no guarantee of any steady income. Investors can gain by appreciation in their capital value over a period of time, but should also be ready to assume the risk of losing a part or whole of the investment.

Bonds

A bond is a debt security, in which the issuer owes the holder of the security a debt, and is obliged to repay the loan amount along with an interest upon maturity of the loan period. In India, the corporate bond market mainly consists of issuers of three different categories- government owned financial institutions (FIs), government owned public sector undertakings (PSUs) and private corporates. The FIs, PSUs and Private corporates which do not have access to retail deposits like banks, depend on bond issues for raising funds. The different types of bonds in the market are fixed rate bonds, floating rate notes, zero coupon bonds, asset backed securities, mortgage backed securities etc.

Real Estate

The Indian real estate sector has been buzzing with activity, and is drawing investment by the hordes. Housing demand in India has been on a boom. Liberal policies on the foreign direct investment (FDI) front have certainly provided a boost to the industry. Real estate as an asset class was not readily accessible for the retail investor, because of the high entry barrier and lack of transparency. However with the advent of real estate mutual funds (REMF), the common investor will be able to participate in the growth of this sector.

Gold

Gold as an investment has held appeal to Indians for centuries. Gold is considered to be an effective hedge against inflation. The yellow metal also provides for a store of value, and has limited downside risk.

Tenets of Financial Planning

Financial planning is unique to each investor based on his individual preferences and needs; however, there are some time-tested tenets which every investor should follow, to protect the downside risk in his portfolio.

Diversification is the first thing that any individual investor should look to build into his portfolio of investments, to minimize the risk associated. Different asset classes do not behave in exactly the same manner over a period of time. For example; the way equity markets behave may not be completely correlated to the returns provided by gold. Therefore, the age old advice of not putting all the eggs in one basket holds true in the investment world as well.

Asset allocation is another important tool which can help an investor immensely. It basically refers to how an investor spreads his investments across various asset classes. This is determined solely by assessing the risk appetite of the investor. Given that level of risk, the process of finding the suitable asset class mix which can help the investor achieve his goal, is known as asset allocation. In conjunction to the idea of diversification, all asset classes may not perform well during the chosen time frame. Therefore, having investment in different asset classes in an optimum mix, enhances the chances of collective good performance, without assuming too much of risk.