Kaushik Paul
MANAGING MONEY GOALS

eBook

PERSONAL FINANCE LESSONS

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UNDERSTANDING RISK

- Inflation Risk
- Market Risk
- Managing Risk

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Personal finance is everything to do with managing your money and saving and investing. We are sharing a series of articles where we shall discuss 9 useful personal finance concepts which everyone should know and learn.

In this first part, we shall understand Risk.

Risk, the word itself creates a sense of fear in the mind. We all want to avoid risk, but unfortunately, we cannot. Risk is everywhere. We cannot avoid it and that's why we must understand the risk and learn the ways to manage it. Being cautious and taking necessary steps to manage risk is better than living in avoidance behavior.

Inflation Risk

All investment products carry risk, even Fixed return products carry risk. Risk of getting a negative real return.

Real Return = Nominal return – Inflation

In the real world, inflation is much higher than the data published by govt agencies. In personal

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finance, the definition of inflation should be, a rate at which your expenses are growing yearly due to price rises and changes in lifestyle. With the increase in lifestyle expenses and constantly decreasing interest rates, fixed-return products hardly can give any real return after adjusting for the effect of inflation.

Market Risk

The definition of market risk is 'Risk of losing money due to market correction or due to falling prices of security bought in the portfolio."

In the case of equity as an asset class market risk is less in long term compared to the short period. The probability of the Sensex or Nifty going down is more in 1 year compared to 5 years. And it is lower in 10 years compared to 5 years.

The amount of market risk is inversely related to the investment holding period. The longer the period, the lesser the market risk is and the shorter the period, the higher the market risk is. In the common language, market risk is also referred to as volatility.

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Managing Risk

To manage risk in your portfolio you need to adequately diversify your investments in equity and debt.

Your short-term investments should be more towards the fixed income category as the risk of inflation will not harm the value of the portfolio much in short term. The risk of inflation is much higher in the long term as its compounding effect can erode the purchasing power of your money considerably in long term.

Your long-term investment should be more towards equity as the market risk is lesser in long term compared to the short term. In the long-term equity can give you a much better return compared to debt and save your portfolio from inflation risk.

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02

UNDERSTANDING RETURN

- CAGR
- IRR – Internal Rate of Return
- XIRR

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The calculating return would have been easier, had we been investing exactly for one year. But that doesn't happen in the practical world. Investment is normally done in a staggered manner and each investment is not kept for the same period of time. Withdrawal also might happen over a period of time.

To compare the return from various investment plans, it is necessary to have a common parameter that can be used for all types of investments with different investment amounts and different holding periods. That common parameter is to assume that all investment returns get compounded annually. If the investment is held for less than one year, then we need to calculate the return in percentage terms by assuming that the investment is held for one year.

CAGR

The Compound Annual Growth Rate (CAGR) is the annual growth of your investments over a specific period of time. In other words, it is a measure of how much you have earned on your investments every year during a given interval.

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If you want to calculate the return for a one-time investment then CAGR (Compounded Annual Growth Rate) is used.

But when the investment is periodically or staggered over a period of time, CAGR is not useful to calculate the return. In the case of staggered investment, either IRR or XIRR can be used.

IRR

IRR is also known as the Internal Rate of return.

If the investment is done in a strictly periodic manner, you may use IRR to find out the rate of return. For example, if the investment is done at fixed intervals (Monthly/quarterly/yearly) and withdrawal happens only at the end of the entire tenure, IRR can be used to find out the return.

Simply stated, the Internal rate of return (IRR) for an investment is the percentage rate earned on each dollar invested for each period it is invested.

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XIRR

XIRR is your personal rate of return. It is your actual return on investments. XIRR stands for Extended Internal Rate of Return and is a method used to calculate returns on investments where there are multiple transactions happening at different times.

If cash flow includes frequent inflow as well as outflow over a period of time, we need to use XIRR for calculating the rate of return. XIRR gives you the flexibility to assign specific dates to each individual cash flow, making it a much more accurate calculation.

Though Return is one of the most important criteria we should also look at other parameters like consistency, portfolio quality, risk, risk-adjusted returns, etc.

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03

ASSET ALLOCATION

- Deciding right Asset Allocation Mix
- Rebalancing Asset Allocation
- Other Important parameters

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As the classic proverb says, 'Don't put all eggs into one basket, Investor also must diversify their portfolio into different asset classes. Why? The reason is very obvious – to reduce the risk.

There are mainly 5 asset classes, namely; Equity, Debt, commodity, real estate, and cash. One must allocate her savings into different asset classes based on the various parameters and her own risk appetite. Dividing your investment into different asset classes based on different parameters is called asset allocation.

Considering the ease of investing and liquidating, we shall focus on two asset classes – Equity & Debt, to understand the process of asset allocation.

Right Asset Allocation Mix

One of the most important criteria while selecting the asset class is the time horizon.

Short Term - If you are looking to invest for less than 3 years, your portfolio should consist of mainly Debt investment as equity is very volatile is very volatile and market risk is higher in short term.

- Medium Term - If you are looking to invest for a period between 3 to 5 years, your portfolio should be a mix of equity and debt.

- Long Term - In case of investment for longer than 5 years, you can invest more into equity. Equity as an asset class is lesser volatile in long term.

Rebalancing

The investment horizon keeps on changing over a period of time. So as the years passed by, asset allocation needs to be re-adjusted based on the remaining number of years till you need to withdraw.

So for example, if you are going to need money in the year 2027, you must start shifting money gradually from equity to debt by the year 2024.

Risk appetite, the required rate of return to achieve your financial goals, tax implications, etc. are other parameters that are also crucial while deciding the right asset allocation mix.

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One must be able to control the GREED in the bull market and FEAR during the bear market to ensure the right asset allocation mix in the portfolio. You must be focused and remain disciplined to save yourself from the emotional decisions which might deviate you from the asset allocation.

“Most important key to successful Investing can be summed up in just two words Asset-Allocation.” Michael LeBoeuf

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04

PORTFOLIO REVIEW

- Understanding importance of review
- How to review schemes

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Understanding Portfolio Review

While investing for any specific goal, we always assume some rate of return from the investment based on some rationale. Actual returns may vary from time to time from assuming returns, so it becomes very important to check whether we are getting that return or not. We also need to check how various asset classes and schemes are performing in our portfolio. This exercise is known as a review and it should be done on a periodic basis. Ideally, once a year, you must review your portfolio.

Reviewing doesn't necessarily mean frequent buying and selling based on performance. The return which we assume is for the CAGR return for the entire period of investment and need not be equal to the assumed CAGR every year.

How to review Schemes

You can review the performance of your scheme and compare it with the performance of the benchmark. Apart from the benchmark, you can also compare it with peer group performance.

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The performance of a good scheme also may lag at some times, so short-term performance should not be given too much weight while doing the review of the portfolio. Rather than short-term performance, you must consider long-term return and consistency in performance.

Apart from the return you also need to compare your portfolio on other parameters like risk, risk-adjusted return, and quality of portfolio while reviewing the scheme.

If the scheme underperforms on all the above parameters you should exit the same and invest in some other scheme.

But, remember reviewing doesn't necessarily mean buying and selling every time, your review. The decision of exiting should not be based on short-term underperformance noticed during the review. You need to adopt a holistic approach to reviewing the scheme by taking into consideration other important parameters also apart from short-term return.

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Once you know where you are going by setting appropriate investment objectives, your portfolio review will help you reach your destination. How? By identifying problems and mistakes that you can correct mid-course. Much like a pilot, your job is to stay on course so that you can reach your destination safely and in a timely manner.

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05

POWER OF COMOPOUNDING

- 8th Wonder
- Start early, Invest regularly
- Challenges

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8th Wonder of the world

If you want to go around the earth and start with 100 meters on the first day and double the distance every day, How long do you think it will take? 1 year? 10 Year?

Let's find out, within 19 days you would have covered 39,321 Kilometers, while the equatorial circumference of Earth is about 40,075 km. you would have traveled around the world in less than 20 Days.

But, What if you stop after 10 days? You would have hardly covered a little less than 77 km.
This is the power of compounding. The power of compounding can help you to create great wealth as well. How to leverage the power of compounding for maximum benefit to create wealth!

Start Early & Invest Regularly

The key ingredient to avail the benefit of the power of compounding is TIME. You need to keep investing regularly for the long term.

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The sooner you start investing in your life, the more wealth you will be able to create.

For Example,

Nisha invests 5000 rupees every month since the age of 25, while Nilesh invests 7000 rupees every month since the age of 35. Both of them kept investing till the age of 60 years with the objective of creating a corpus of retirement.

By the age of 60 both would have invested 21 Lac rupees. Assuming a return of 12%, How much wealth both of them would have created for their retirement?

Nisha will accumulate 2.75 Crore rupees, while Nilesh will get only 1.19 Cr rupees, which is 59% lesser than Nisha's corpus.

This is why starting early is important.

Challenges

"I fear not the man who has practiced 10,000 kicks once, but I fear the man who has practiced one kick 10,000 times." Bruce Lee

It requires a lot of discipline to keep doing the

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same thing again and again for the long term, though it is the most proven method to create a great result in any area.

To avail, the benefit of the power of compounding the biggest challenge is to keep investing every month with discipline. And as human beings, most of us lack discipline, when it comes to following the same routine with the absence of instant gratification. For creating wealth in long term, one needs a lot of discipline to start early and keep investing regularly.

Solution

Start a SIP (systematic investment plan) in Equity Mutual Fund for the long term to automate the process of investing. You need to exercise your willpower just once to decide the amount and tenure and to start your SIP. The biggest benefit of investing in a mutual fund through SIP is that it helps you in investing with discipline regularly. You need not do paperwork or pay every month manually. This automation makes this long-term powerful process of wealth creation easier for you.

06

IMPORTANCE OF DIVERSIFICATION

- Understanding Diversification
- Importance of Diversification
- How to diversify?

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Understanding Diversification

Diversification is investing in investment options to limit exposure to any particular asset class or investment. This practice helps to reduce the risk associated with your portfolio. Simply put, diversification helps you to yield higher returns as well as reduce the risk in your portfolio. Balancing your comfort level with risk against your time horizon is one of the keys to a long successful investing journey.

For e.g., keeping pace with inflation may not be easy if you start investing in conservative investment options from a young age. On the other hand, taking a large exposure to high-risk instruments near retirement could erode the value of your portfolio. Hence, it is important to balance the risk and reward in your portfolio so that you don’t lose sleep on market ups and downs.

The major components of a diversified portfolio are equity, debt, and money market instruments. Equity investments carry the highest risk in your portfolio and it has the potential to give higher returns over the long run. But with higher return

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equities tend to be more volatile than other asset classes. Investing in equity mutual would be the best way to take exposure to equities. Equity mutual funds are diversified funds as fund managers invest in different stocks and across sectors (except sectoral funds) which optimizes the risk in your portfolio.

Another important component of a diversified portfolio is debt securities. While equities have the potential to grow your wealth, debt investments provide stability and act as a cushion through the market cycles.

Debt instruments include debt mutual funds, fixed deposits, bonds, etc. The main objective of debt instruments is not to provide high returns like equities but capital protection along with inflation-beating returns. Debt investments can also be a source of income.

While equity investments give higher returns and debt instruments protect the capital to help us fulfill our financial goals, a part of the portfolio should be in liquid and money market instruments such as liquid mutual funds or a separate savings account. It provides easy access to money during emergencies such as job loss or accidents.

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Importance of Diversification

Diversification helps to minimize the risks associated with your portfolio. Let us assume that two years ago, you had invested your entire savings in a particular airline stock. Now, the airline is near bankruptcy and the stock price went down 60% in one month. Would you be comfortable in that kind of scenario? Most people wouldn't. You would have been less stressed out if you had diversified your portfolio and invested in a few other companies rather than taking 100% exposure in one particular stock.

Diversification is important because different investment options react differently to the same development or move in a different pattern. For example, real estate and gold tend to underperform when equity markets are soaring. A cut in the interest rate may benefit the bond market but may not be good news for individuals with fixed deposits.

How to diversify

Diversifying your portfolio is as healthy as consuming green leafy vegetables, and fruits,

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exercising, and meditating on a regular basis. However, eating just one kind of fruit may not be very effective. Hence, it is important to diversify. Investment is no different. Here are some of the ways through which you can diversify your portfolio:

Spread your investments among different asset classes: A diversified portfolio should include equities, debt, and cash. Exposure to the international market and commodities such as gold can help you further diversify your portfolio. It is because different investments come with different risks and returns. Higher the returns, higher will be the risk and vice versa.

Diversify within individual types of investments: Diversification is also necessary within an asset class. For e.g. in the case of equity mutual funds do not concentrate on one category. It is recommended that you have mutual funds across market capitalization such as large-cap funds, mid-cap funds, and different investment strategies. Different funds and stocks come with varying risks thus minimizing the risks.

Rebalance your portfolio regularly: Diversification is not a one-off exercise. Rebalancing your portfolio depends on two important things which are the number of years until you expect to need money(time horizon) and risk-taking capacity(risk tolerance).

In a Nutshell,

To summarise, diversification is important for every investor whether it is across asset classes or within an asset class. The nature of diversification depends on financial goals, time horizons, and risk tolerance. It is also important that the diversification of the portfolio is updated on a regular basis.

"If you invest and don't diversify, you're literally throwing out money. People don't realize that diversification is beneficial even if it reduces your return. Why? Because it reduces your risk even more. Therefore, if you diversify and then use margin to increase your leverage to a risk level equivalent to that of a nondiversified position, your return will probably be greater." Jeff Yass

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Thank you for reading and we hope that this eBook provides you with valuable insights into the importance of asset allocation.

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