Bij Investment Consultants

Personal Financial Planning

Financial Planning

- Financial planning is a **Planned and Systematic Approach to provide for the Financial Goals** that will help people realize their needs and aspirations, and be happy.
- Everyone has needs and aspirations.
- Most needs and aspirations call for a Financial commitment.

Financial Planning

- Providing for this **commitment becomes a Financial goal.**

- Fulfilling the Financial Goal sets people on the path towards realizing their needs and aspirations.

- People experience happiness, when their needs and aspirations are realized within an identified time frame.

Financial Planning

- **Example**: A Father wants his son, who has just passed his 10th standard Board examinations, **to become a Doctor**.
- This is an aspiration. In order to realize this, formal education expenses.
- The Estimated Financial Commitments towards these expenses become Financial Goals.
- These Financial Goals need to be met, so that the son can become a doctor.

Financial Planning

- Goal Assessment
- Investment Time Horizon
- Assessing Required Investment

Financial Planning

Goal Assessment

Estimate of Future Expenses

- How much would be **the expense**, if it **were incurred today (PV)?**
- How many Years **down the line**, the **Expense will be incurred?**

Financial Planning

Goal Assessment

Estimate of Future Expenses

- During this period, how much is likely to be the rise in Expense on account of **Inflation**?
- If any of expenses are **to be incurred in Foreign Currency**, then how would changes in Exchange Rate affect the Financial Commitment?

Financial Planning

Goal Assessment

Estimate of Future Expenses

Year	Current Cost	Inflation	Exchange Rate Impact	Future Requirement
1	100000	7%	NA	107000
2	120000	7%	NA	137388
3	1000000	7%	NA	1225043
4	500000	7%	NA	655398
5	500000	7%	NA	701276
6	500000	7%	2%	838550
Total	2720000			3664655

Financial Planning

Investment Horizon

- The **Year-wise Financial Goals** statement <u>throws up the investment horizon</u>.
- It would be **risky to expect the first three to five years expenses to be met out of equity** investments being made today.
- But equity is a viable investment option for expenses beyond that period.

Financial Planning

Investment Horizon

- In most cases, the investor would have some regular income out of which part of the expenses can be met.
- So the **Investments being considered** now need **to fund only the Balance of the Financial Goals**.

Financial Planning

Assessing Investment Requirement

- Suppose the investor is comfortable about meeting Rs.100,000 of the expense each year.
- The balance would need to be provided out of investments being made today.
- How much is that investment requirement?

Financial Planning

Assessing Investment Requirement

- This can be calculated using a variation of the formula

$$P = A / (1 + r)^n$$ where:

- A = Rupee requirement in future
- P = Present Value
- n = Number of years into the future, when the expense will be incurred.
- r represents the return expected out of the investment portfolio.

Financial Planning

Assessing Investment Requirement

- This can be calculated as following:

Year	Current Cost	Regular Savings	Balance	Calculation	Future Requirement
1	107000	100000	7000	=7000/(1+0.06)^1	6604
2	137388	100000	37388	=37388/(1+0.06)^2	33275
3	1225043	100000	1125043	=112504/(1+0.06)^3	944608
4	655398	100000	555398	=555398/(1+0.09)^4	393458
5	701276	100000	601276	=601276/(1+0.09)^5	390788
6	838550	100000	738550	=738550/(1+0.09)^6	440373
Total	3664655				2209106

Financial Planning Objectives & Benefits

- The Objective of Financial Planning is **to ensure that the right amount of money is available at the right time** to meet the various financial goals of the investor.

This would help the investor realize his aspirations and experience happiness.

Financial Planning Objectives & Benefits

- An Objective of Financial Planning is also to **let the investor know in advance, if some financial goal is not likely to be fulfilled**.

In the above case, the investor knows that if he cannot make the requisite combined investment of Rs. 22,09,106 in debt and equity today, then financial constraints may affect the realization of his aspiration.

Financial Planning Objectives & Benefits

- Timely corrective actions can be taken, such as:

❖ Reviewing what is a "need" as compared to a "desire" that can be postponed for the more desirable objective of realizing the aspiration of son becoming a doctor.

❖ Moving to a smaller house, or a house in a less expensive locality, to release more capital.

❖ Improving the Future Annual Savings by economizing on expense, or taking up an extra part-time job, or influencing the spouse to take up employment for some time..

Financial Planning

- **Goal-oriented Financial Plan** – a Financial Plan for a **Specific Goal related** to the aspiration to make the son a doctor.

- **Comprehensive Financial Plan** where **all the Financial Goals of a person** are taken together, and the investment strategies are worked out on that basis.

Financial Planning

- The Comprehensive Financial Plan <u>captures the estimated inflows from various sources</u>, and <u>estimated outflows</u> for various financial goals, including post-retirement living expenses. <u>The plan can go several decades into the future</u>.
- A Comprehensive Financial Plan calls for significantly more time commitment on the part of the investor.

Financial Planning Steps

- Life Cycle
- Wealth Cycle
- Risk Profiling
- Asset Allocation
- Model Portfolio
- Scheme Selection

Financial Planning Steps

Life Cycle

- Childhood
- Young Unmarried
- Young Married
- Married with Young Children
- Pre-Retirement
- Retirement

Financial Planning Steps

Wealth Cycle

- Accumulation
- Transition - Financial Goals are in the Horizon
- Inter-Generation Transfer
- Reaping / Distribution
- Sudden Wealth

Financial Planning Steps

Risk Profiling

Factor	Influence on Risk Appetite
Family Information	
Earning Members	Risk appetite increases as the number of earning members increases
Dependent Members	Risk appetite decreases as the number of dependent members increases
Life expectancy	Risk appetite is higher when life expectancy is longer

Financial Planning Steps

Risk Profiling

Factor	Influence on Risk Appetite
Personal Information	
Age	Lower the age, higher the risk that can be taken
Employability	Well qualified and multi-skilled professionals can afford to take more risk
Nature of Job	Those with steady jobs are better positioned to take risk
Psyche	Daring and adventurous people are better positioned mentally, to accept the downsides that come with risk

Financial Planning Steps

Risk Profiling

Factor	Influence on Risk Appetite
Financial Information	
Capital Base	Higher the capital base, better the ability to financially take the downsides that come with risk
Regularity of Income	People earning regular income can take more risk than those with unpredictable income streams

Financial Planning Steps

Asset Allocation

- The discussions on various asset classes highlight the **Unpredictability of Markets**.
- Different Asset classes perform well in varied Economic and Market Scenarios.
- The Analyst seeks to interpret the leading indicators and anticipate likely market trajectory.

Financial Planning Steps

Asset Allocation

- It is impossible to predict the market with certainty.
- An **Approach to Balance the Uncertainty** is to **Invest in a Mix of Asset Classes**.
- This ensures that **some asset classes in the portfolio perform well, when others don't**. Such distribution of investments portfolio between asset classes is "**Asset Allocation**".

Financial Planning Steps

Asset Allocation

- **Perpetual Debt** represents an extremely Safe portion of the debt market as it has a date on which the principal is scheduled to be repaid. This feature of debt makes it safer than equity.
- Investors find difficult to handle the fluctuations in equity.
- **Allocation of investment between risky and relatively less risky asset classes** makes it smoother for the investor to fulfil his financial goals.

Financial Planning Steps

Types of Asset Allocation

- Strategic
- Tactical
- Fixed
- Flexible

Financial Planning Steps

Strategic Asset Allocation

- Distribution between Asset Classes **based on Risk Profile of the Investor** is called "Strategic Asset Allocation'.

Financial Planning Steps

Strategic Asset Allocation

- **A Young Investor**, who is in the Accumulation Phase can afford to take more risk.
- Even if he were to Lose Money, he can recover it from Future Earnings.
- Liberal portion of Risky Growth Assets that are likely to protect from Inflation. Such an investor may be advised to have an **Equity-Debt mix of 80:20.**

Financial Planning Steps

Strategic Asset Allocation

- **A Senior Citizen** is exposed to inflation and the exposure is for a shorter time period determined by Life Expectancy.
- Besides, he may not have a Future Earnings stream to make up for losses.
- These factors mandate a significantly lower exposure to risky assets. Such an investor may be advised to have an **Equity-Debt mix of 20:80**

Financial Planning Steps

Strategic Asset Allocation

- A **Investor in Transition mode** knows that a large requirement of funds is coming up **calling for Liquidity in the short term**.
- The Market Conditions may be unfavourable, so Client should exit some investments much earlier and park the funds in debt.
- Once the **purpose is settled**, the investor may back to the strategic asset allocation suggested by the risk profile.

Financial Planning Steps

Strategic Asset Allocation

- A **Investor Earned Windfall Gains** may choose to invest in risky assets.
- But it would not be advisable to invest all the money at the same time.
- The investor may therefore opt to invest in a liquid fund, with a STP into an equity fund. Until the STP is completed, the investor will find himself over-invested in debt.

Financial Planning Steps

Tactical Asset Allocation

- Investors who are Oriented to take Risk do take asset allocation calls based on their **Views of the Market.**
- When they feel the market is undervalued they **increase their Exposure to Equity** and Exit when the view is that the market is overheated.
- This approach is called Tactical asset allocation.

Financial Planning Steps

Tactical Asset Allocation

- Tactical asset allocation is **clearly a risky style of investing**.
- Wrong market calls can cause serious losses to the investor.
- Therefore, this approach is **suitable only for Wealthy Investors** who are in a position to take risk.

Financial Planning Steps

Fixed Asset Allocation

- An investor who practices **Fixed Asset Allocation** will seek to maintain the allocation even when the market moves.
- **Example:** An investor's portfolio is structured with **Equity to Debt Mix of 30:70**.
- In a short period, if the Equity Market were to go up by 70%, 30 will become 51.

Financial Planning Steps

Fixed Asset Allocation

- During this phase, if debt gave a 5% return, 70 would have become 73.5.
- Thus, the equity-debt mix has now become 51: 73.5, which can be re-written as 41:59. The complexion of the portfolio has changed.
- An investor adopting Fixed Asset Allocation will **re-balance the portfolio** in such a situation.

Financial Planning Steps

Fixed Asset Allocation

- This would entail selling some equity and re-investing in debt. Thus, the investor ends up booking profits in the rising market.
- Until the **Desired Asset Allocation** is reached, the investor will keep investing fresh surpluses in the asset class where he is short.

Financial Planning Steps

Fixed Asset Allocation

- Portfolio re-balancing does entail costs such as brokerage and stock exchange charges.
- **Profits booked** may also become liable for short term capital gains.
- Most investors therefore do not try to re-balance more frequently than annually.

Financial Planning Steps

Fixed Asset Allocation

- Most mutual fund schemes operate with a Fixed asset allocation, though within a wide investment range defined in the Offer Document.
- **Example:** the proposed investment distribution may be defined in the Offer Document:

❖ Equity and equity related securities 70 – 90%

❖ Debt and debt related securities 10 – 30%

Financial Planning Steps

Fixed Asset Allocation

- **Mutual Fund schemes do not pay a tax on their Capital Gains or Losses**.
- So Portfolio-rebalancing is more efficient when it is handled by the scheme, as compared to any other investor.

Financial Planning Steps

Flexible Asset Allocation

- As per the previous example of investor with **Equity: Debt mix of 30:70, which changed to 41:59** when the market changed, so investor adopting Fixed Asset Allocation will Re-balance portfolio to arrive at the targeted Equity: Debt Mix.
- An Investor who adopts Flexible Asset Allocation will **allow the Equity : Debt Ratio to drift**, i.e. **No Re-balancing in line with the market.**

Financial Planning Steps

- **Flexible Asset Allocation**
- This kind of lazy approach to investment is not desirable.
- This is not meant to be lazy investing, but part of a tactical approach to investment.
- The Mutual Funds scheme retains its flexibility to increase exposure to any Asset Class, depending on the Fund Manager’s view on the markets.

Financial Planning Steps

Model Portfolio

- **Young Call Centre/BPO Employee with no dependents**

- 50% Diversified Equity Schemes (preferably through SIP)
- 20% Sector Funds
- 10% Gold ETF
- 10% Diversified Debt Fund
- 10% Liquid Schemes.

Financial Planning Steps

Model Portfolio

- **Young Married Single Income family with two school going kids**

- 35% Diversified Equity Schemes
- 10% Sector Funds
- 15% Gold ETF
- 30% Diversified Debt Fund
- 10% Liquid Schemes.

Financial Planning Steps

Model Portfolio

- **Single Income Family with grown up children who are yet to settle down**
  - 35% **Diversified Equity Schemes**
  - 15% Gold ETF
  - 15% Gilt Fund
  - 15% Diversified Debt Fund
  - 20% Liquid Schemes

Financial Planning Steps

Model Portfolio

- **Couple in their Seventies, with no immediate Family Support**

❖ 15% Diversified Equity Index Scheme

❖ 10% Gold ETF

❖ 30% Gilt fund

❖ 30% Diversified Debt Fund

❖ 15% Liquid Schemes.

Thank You