3. SMART GOALS

A critical first step in managing your finances is to be able to setup SMART financial objectives. Your goals have to be S (specific), M (measurable, motivated), R (realistic, resource-based), and T (time-bound, can be monitored). Many people make the mistake of setting general goals which, more often than not, will not materialize.

Objectives	Goals	Incorrect Approach	Right Approach
Specific	You need to know exactly what you want and when	I need money to pay my college fees in a year's time	I will save the money of Rs. 50,000 to pay my fees at college
Measurable	Your goal should be measurable so that you know when you can achieve it	I will pay off my debts to my friends	In the next six months, I will return Rs 3000 to my two friends for lending me their money.
Attainable	Your goals should be reasonable i.e. within your reach	I will save money.	I will save Rs. 2,000 each month by cutting down on eating out and partying.
Realistic	Your goals need to be based on resources and tasks that you can reasonably accomplish.	If I save money I will be rich.	If I save regularly, need not borrow more money, I can pay off my debts by next year and will have enough savings till I begin to earn.
Time-bound	Goals with timelines allow you to track your progress and encourage you to keep going until you reach your goal	I will save money for my vehicle	I will save Rs.10000 a year for the next 2 years for my vehicle.

4. HOW TO ACHIEVE YOUR GOALS?

NIKHIL: Now that you know the different aspects of financial planning let us chalk out few goals of yours and how you can go about achieving them. Tell me what are your goals for the future?

SHANTANU: Yes. I would first like to finance my education and then a two wheeler.

NIKHIL: You should write your goals depending upon when you want to achieve them this will help you categorize them.

Table 1: Goals for Mr. Shantanu *Age: 21 Years*

Goals	Goal Type	Name	Target Date	Amount(Lakh)
Education	Short term	Self	2011	05.00
Two-wheeler	Medium term	Self	2014	00.50
Vacation	Medium term	Parents	2016	1.00
Marriage	Long term	Self	2018	10.00
House	Long term	Self	2020	60.00

Once you do this you should plan your investments accordingly.

Goal	Goal Type	Target Date	Action plan required
Education	Short term	2012	Finance your fees partly from your parents funds and partly by taking loan
Two-wheeler	Medium term	2015	By 2013 it is expected you would begin to earn money. So you can save 10 thousand every year so in three years you can have enough funds to buy a vehicle
Vacation	Medium term	2018	Also keeping in mind this goal you can make suitable investments like equity and mutual funds to earn sufficient returns to fund the vacation for your parents provided you plan well in advance
Marriage	Long term	2020	Make investments in equities, debt and mutual funds which will give you sufficient returns to cover your expenses
House	Long term	2022	You can make investments in Fixed deposits which will help you to lock away funds for this goal, however as this would not be enough you should look at other options as well

5. RISK V/S RETURNS

Every individual has their own risk taking capacity. Your risk-return profile is your level of risk tolerance. If you invest in a high risk business like a start up firm your risk would be high. There are three types of risk return profiles which you can fall under depending upon your source of funds and the investments you choose to make. They are:

1. Conservative i.e. you take minimal risks ensuring your funds are secure. You prefer investing in post office deposit schemes, bank fixed deposits, government bonds
2. Moderate i.e. you are willing to take some risks and prefer investing in mutual fund schemes
3. Aggressive i.e. you are willing to take high risks and prefer investing in equity, commodities markets and you may even be speculating for returns.

There is an important investment principle which says the level of your returns depends on the level of risk you take. While you stay invested it is crucial you take necessary measures to manage your risk. Once you invest in any asset class you should monitor your investments and keep yourself updated about various market happenings to avoid any pitfalls. Always check the potential risks when quoted returns are unusually high.

6. THE POWER OF COMPOUNDING

Time is an influential factor when it comes to investments. Your returns depend upon the time you enter and exit. Compounding is a concept which when followed with dedication gives great rewards. However, it rewards better when savings are compounded over longer horizons. Compounding, in short, basically means earning interest on previously earned interest. Let us look at an example:

If you set aside a sum of say Rs 5,000 every month from the age of 25, at a return interest rate of 10%, in 60 years you will have with you funds worth about Rs 1 crore (Rs 10 million) and more. However, if you start at 40 with the same amount and return rate of interest, the retirement fund will amount to only around Rs 33 lakh (Rs 3.3 million).
Consider you invest Rs 100 for a period of 5 years.

Year	Amount (at 10% fixed rate of interest)	Floating rate of interest	Amount (terms of floating rate)
1	110	10%	110
2	121	9%	119.9
3	133.1	12%	133.50
4	146.41	10%	146.8508
5	161.05	9%	160.06

Notice here that the Rs 100 that you had invested will fetch you Rs 161.05 in 5 years in terms of fixed interest rate and similar results in terms of floating rate as well. Thus in 5 years you stand a chance of making around 60% return!!!

Thus compounding is a tool that helps you make phenomenal growth in your investments over a period of time. Thus the more time you have, the more money you are capable of making and this is exactly why financial planning is so very important.

Recurring deposits and SIPs can help you on this front, ease in payment of this regular investment amount through a direct debit facility or post-dated cheque can help you execute your compounding strategy.

7. INFLATION EFFECTS ON INVESTMENTS

Inflation is rise in prices for goods and services. As the prices rise, lesser number of people can buy them. Let's say the rate of petrol changes from Rs 40 to Rs 45, with no change in quality. Then the price difference indicates inflation.

If you are earning returns of 10% over your investment of Rs 5000 which is Rs. 500 after a year and the inflation rate is 11% then you will end up giving your returns due to high inflation rates. Hence always ensure your returns are above the inflation rates. You should also understand the time value of money.

Time Value of Money

SHANTANU: Yes. I know about the time value of money. I remember our Investment Professor telling us about this. He gave us an assignment to help us understand this. He asked us to find out the value of things in our house, which we use the most, and to list down their price or value today and their value 5 years back. We found out that when we compared their values, their value today was much higher.

NIKHIL: This is because of the time value of money. As time passes you will realize that if 10 years back you could afford to purchase a full lunch for Rs 10, today you might afford to get few pieces of vegetables only. This means that the value of a thousand rupee note would be higher today than after five years. If you invest Rs 1000 today, at 5% per annum, then after a year you would receive Rs 1050. Thus Rs 1000 received today is equivalent to Rs 1050 received after a year. In order to protect one's money from losing its value people invest their money. Now I guess you understand your rationale for investing in stock markets was wrong. What you also need to know is that borrowing and spending is not that easy. When you borrow you take up a liability that is you agree to repay and the amount you repay is the original amount you had borrowed along with an interest payment, which is levied upon the amount you borrow.

Activity 2: List down the various items you often use and write down their value today and its value 10 years back. Compare the two values and observe how the value of money has changed over time.

TIME VALUE OF MONEY			
Commodity	Price then (2001-02)	Price now (2009-10)	% increase in inflation
Sugar (1kg)	16.00	40.00	150.00%
Cooking Oil (5 liters)	290.00	500.00	72.41%
Gold (10 grams)	4474.00	17138.00	283.06%
Silver (1 kg)	7868.00	28345.00	260.26%
Rice (1 kg)	14.00	35.00	150.00%
Wheat (1 kg)	10.00	30.00	200.00%
Petrol (1 liter)	33.46	48.83	45.94%
Diesel (1 liter)	19.88	36.74	84.81%

Source: For bullion prices – RBI, the prices of other commodities are approximate prices from web sources

Example 2: Now if you want to buy a house after 20 years the amount of saving and investment required to be made every month at various rates of return to build up corpus of various amounts will be;

Corpus required / Interest rate	50,00,000	60,00,000	70,00,000	80,00,000	90,00,000	10,00,000
6%	10,973.44	13,168.12	15,362.81	17,557.50	19,752.19	21,946.87
8%	8,731.18	10,477.42	12,223.66	13,969.89	15,716.13	17,462.37
10%	6,906.20	8,287.44	9,668.69	11,049.93	12,431.17	13,812.41
12%	5,435.63	6,522.75	7,609.88	8,697.00	9,784.13	10,871.25
15%	3,767.69	4,521.23	5,274.76	6,028.30	6,781.84	7,535.38

Example 2: Suppose your parents are to retire and you want to build up a corpus for their retirement then how much of corpus is required at their retirement to get continuous flow of cash for their monthly expense requirement at 7% rate of return and 5% inflation rate?

Monthly expenses / years to retire	10,000	12,000	15,000	18,000	20,000	25,000
5	5,73,081.76	6,87,698.12	8,59,622.64	10,31,547.17	11,46,163.53	14,32,704.41
10	10,94,691.47	13,13,629.77	16,42,037.21	19,70,444.65	21,89,382.95	27,36,728.68
15	15,69,452.16	18,83,342.59	23,54,178.24	28,25,013.89	31,38,904.32	39,23,630.40
20	20,01,571.62	24,01,885.95	30,02,357.43	36,02,828.92	40,03,143.24	50,03,929.05
25	23,94,879.74	28,73,855.68	35,92,319.61	43,10,783.53	47,89,759.47	59,87,199.34

Example 3: Monthly investment you require to build your corpus_____
Assumption: You can take interest rate as per your risk profile.

Assumption: You can take interest rate as per your risk profile.

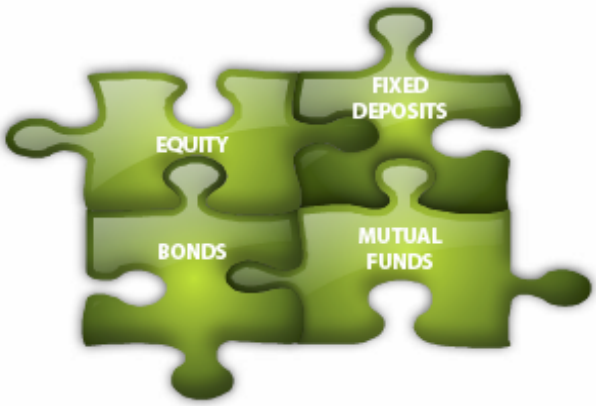
For calculation purpose, amount that you have to invest regularly to build the corpus of Rs.10 lakhs. If your requirement is 20 lakhs, then multiply the monthly investment amount by

Interest rate / No of year	6%	8%	10%	12%	15%
5	14,321.72	13,621.38	12,958.11	12,329.91	11,449.24
10	6,125.04	5,516.23	4,963.82	4,463.57	3,802.02
15	3,468.51	2,943.09	2,489.91	2,101.14	1,622.41
20	2,194.69	1,746.24	1,381.24	1,087.13	753.54
25	1,471.50	1,093.09	804.40	587.47	362.77
30	1,021.18	705.41	480.93	324.57	177.56

What are the measures I can take to minimize my risk?

Diversification

SHANTANU: Why do I need to invest in various asset classes? Rather if I invest in just one I don't have to maintain a huge portfolio. Also, managing just one asset class sounds a lot easier. I can also save on the portfolio manager's fees too.



NIKHIL: Well, when it comes to investments one should remember that investing in various asset classes has its own advantage. When you distribute your investment across various asset classes, your risk is balanced out across the portfolio. Let me give you an example.
(Look at how Nikhil explains diversification in the following steps.)

Asset Allocation	
Funds	Rs 10, 000
Investments - Stocks	Rs 3500
Bonds	Rs 3500
Bullion	Rs 3000

NIKHIL: Suppose the amount available with you for investing is Rs 10, 000. You make investments in various assets. You invest Rs 3500 each in equity (which are shares or stock of a company) and bonds which may be government securities or corporate bonds. The rest of the funds are allocated to commodities, let's say gold or silver, which is termed as bullion in commodity markets. Now, say the company's shares in which you have invested have not performed well then there is a possibility that you may lose money on the capital invested in these shares. However, since you have invested in other asset classes the decrease in value of any one asset will be balanced by the gain in other asset classes. This is the benefit of diversification. Diversification thus reduces the risk of the portfolio. If two asset classes are correlated, it implies that when one asset class does not perform well the other asset also loses value depending upon the extent to which they are correlated. If they are positively correlated the direction of movement would be the same but if they are negatively correlated they would move in opposite directions. Investors park their funds in different asset classes with a motive to even out the losses in one asset with the gains in other asset classes. One should always analyze the fundamentals of the company before investing in its products. If one wishes to invest in equity markets, he or she may choose to do so by investing in blue chip companies which have good fundamentals rather than investing in companies whose business you do not understand.

Asset Allocation

Every asset class has its own risks and returns. Equity investments are considered to be risky investments as they might lead to erosion of entire capital invested, whereas government bonds are considered to be risk free as you are confident that the government will not default on its interest payments. When it comes to choosing what investments would suit you, a financial planner will tell you about various asset classes and will help you allocate your funds appropriately. This is termed as asset allocation. In other words, now you would begin implementing your financial plan. Asset allocation is a technique for investing your money into various asset classes. Your planning consultant will suggest assets that would suit you according to your income and risk appetite. If your risk appetite is high, he would suggest risky assets, but if your risk appetite is low, then he would suggest less risky assets. While allocating your funds to various assets, it is important to see that you distribute your funds across various assets to benefit from diversification.