The core idea behind 'time value of money' is that, a rupee 'today' can earn and grow with time. That is why a rupee today, is worth more than a rupee in the future. This is based on potential earning capacities.

Let us take an example: You are given an option of receiving 1 lakh now or 1 lakh after 5 years. Which option you would choose. Obviously you would select 1st option because money loses its value over a period of time.

This is due to following reasons –

Inflation- It is a key factor which reduces the purchasing power of money over a time. Rs. 1 lakh can be used to buy more goods and services today than Rs. 1lakh in 5 years from now.

Opportunity cost- The opportunity cost of not having the money right now also includes the loss of additional income that you could have earned simply by having received the cash earlier.

Risk v/s return- Receiving money in the future rather than now may involve some risk and uncertainty regarding its recovery, which is known as default risk. So you expect interest or return to compensate that risk.

Thus it's clear from above listed reasons that future cash flows are worth less than the present cash flows. Three reasons may be attributed to the individual's time preference for money - risk, interest earning potential and preference for consumption.

Time Value of Money concept attempts to incorporate the above considerations into financial decisions by facilitating an objective evaluation of cash flows from different time periods by converting them into present value or future value equivalents. This ensures the comparison of 'like with like'.

So while taking a financial decision i.e. whether spending the amount on any discretionary thing or investing or borrowing money, time value of money has a major role to play. For e.g. buying a House now or after few years or on loan can be taken most effectively by analyzing various elements involved like goal priority, down payment, investment returns, loan interest rate etc.

An investor requires compensation for assuming risk, which is called risk premium. The investor's required rate of return is: Risk-free rate + Risk premium.

Time Value of Money also considers selecting right investment channel i.e. selecting low risk product even when the investment horizon of your goals and your risk appetite is high then you are condemning your corpus to lower earnings and compounding benefits.

Two most common methods of adjusting cash flows for time value of money: Compounding —the process of calculating future values of cash flows and discounting—the process of calculating present values of cash flows.

Other things which on face seems to be small but if ignored due to laziness/ lack of time or skill can drain your corpus over a period of time -the fees & cost associated with financial

products & services, reinvestment of interest & dividend received, evaluating of your investments periodically etc.

Many times we believe that we can take care of all our investments but still we all face some or other issues described above. Setting in place a system and schedule for making and monitoring investments, and automating much of the process is one way of avoiding the slips. But you still need expertise for evaluating products and analyzing performance. So a good way to take care of all these issues would be to acquire these skill sets over time or appoint a professional adviser to help you manage it. It may well bridge the gap between where you are and where you want to be.

The author Deepak Jasani is the head of retail research at HDFC Securities. Views expressed are his own