CHAPTER 1: INTRODUCTION TO PERSONAL FINANCIAL PLANNING

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Concept of Financial Planning
- Need for financial planning
- Scope of financial planning
- Concept of asset, liabilities and net worth
- Financial Planning process
- Financial advisory and execution

1.1 Understand the concept of Financial Planning

Financial planning aims at ensuring that a household or individual has adequate income or resources to meet current and future expenses and needs. The regular income for a household or individual may come from sources such as profession, salary, business or even investments. The normal activities of a householdor individual and the routine expenses are woven around the regular income and the time when this is received. However, there are other expenses that may also have to be met out of the available income.

The current income that is received must also provide for a time when there will be no or low income being generated, such as in the retirement period. There may be unexpected expenses which are not budgeted, such as a large medical expense, or there may be needs in the future that require a large sum of money, such as education of children or buying a home, all of which require adequate funds to be made available at the right time. A portion of the current income is therefore saved and applied to creating assets that will meet these requirements. Financial planning refers to the process of streamlining the income, expenses, assets and liabilities of the household or individual to take care of both current and future need for funds.

Example

Vinod is 40 years old and earns Rs.2 lakhs a month. He is able to save about Rs.40,000 a month after meeting all the routine expenses of his family, paying the loans for his house, car and other needs. His investments include those for tax savings, bank deposits, bonds and some mutual funds. He pays premiums on life insurance for himself and his wife. Vinod is the sole earning member of his family and he believes he takes care of his finances adequately to take care of his current and future needs. How would financial planning help him?

The following are a set of indicative issues that financial planning will help Vinod resolve:

a) As the sole earning member has he made provisions for taking care of his expenses by creating an emergency fund if his current income is interrupted for any reason?
b) Does he have adequate insurance cover which will take care of his family's requirements in the event of his untimely demise?
c) Does the family have adequate health insurance cover so that any medical emergency does not use up all the accumulated savings?
d) What are his specific future expenses and how will he fund them?
e) If Vinod has to create a corpus to fund large expenses in the future, what is the size of the investment corpus he should build?
f) Given his current income and expenses is he saving enough to create the corpus required?
g) Will he have to cut back on his current expense or can he increase his current income so that his expenses in the present and the savings for the future are met?
h) What is the wealth Vinod has so far built from his savings and how can he best use it to meet his needs?
i) How should his saving be deployed? What kinds of investments are suitable for Vinod to build the required corpus?
j) How much of risk is Vinod willing and able to take with his investments? How would those risks be managed?
k) How should Vinod ensure that his savings and investments are aligned to changes in his income, expenses, future needs?

A formal treatment of the issues that Vinod faces will require a financial planning process to assess the current situation; identify the current and future needs; determine the savings required to meet those needs and put the savings to work so that the required funds are available to meet each need as planned.

Financial planning is thus a process that enables better management of the personal financial situation of a household or individual. It works primarily through the identification of key goals and putting in place an action plan to realign the finances to meet those goals. It is a holistic approach that considers the existing financial position, evaluates the future needs, puts a process to fund the needs and reviews the progress.

1.2 Understand the need for financial planning

There is a large range of financial products and services that are available for investors today and these need to be linked to the specific needs and situations of the client. Not every product may be suitable to every client; nor would a client be able to identify how to choose and use products and services from the choices that are available in the market. Financial planning bridges this gap as the Investment Adviser possesses the expertise to understand the dynamics of the products on the one hand and the needs of the client on the other. This makes them best suited to use such products and services in the interest of the client.

1.2.1 Role of the Financial Planner

The Financial Planner has a significant role to play when it comes to advising clients because the needs of each person are different front that of the other.

a) The financial planner has to recognise the exact needs and goals of an individual and a household or family and then make efforts to ensure that these needs or goals are achieved.

b) Personal financial management requires time and attention to recognize income and expense patterns, estimates of future goals, management of assets and liabilities, and review of the finances.

c) Individuals do not have time to undertake all these detailed financial activities in a busy world and they need someone like a financial planner to focus on this area and help them in their efforts.

d) It is not easy to set financial goals and this requires specific expertise and skill which may not be present with most individuals.

e) Every financial goal requires finding a suitable product and a proper asset allocation to different asset classes so that this can be achieved, which is where the financial planner steps in.

f) Selecting the right investment products, choosing the right service providers and managers, selecting insurance products, evaluating borrowing options and such other financial decisions may require extensive research. A financial planner has capabilities to compare, evaluate and analyse various products which enables making efficient choices from competing products.

g) Asset allocation is a technical approach to managing money that requires evaluating asset classes and products for their risk and return features, aligning them to the investor's financial goals, monitoring the current and expected performance of asset classes and modifying the weights to each asset in the investor's portfolio periodically to reflect this. Financial planners with technical expertise enable professional management of assets.

h) Financial planning is a dynamic process that requires attention to the constantly changing market and product performances and matching these with the dynamic changes in the needs and status of the client. This kind of attention can be provided by a financial planner.

1.2.2 How is financial planning different from typical financial advisory services?

Financial planning requires following of a specific process wherein the client along with their overall needs and goals are at the core of everything being done. Other financial advisory services would normally look at meeting just a specific need like advising on stocks or debt but the relation with other aspects might be missing.

The financial planning effort is a comprehensive process as it covers all aspects of a client's personal financial requirements including retirement, insurance, investment, estate and others. A typical financial advisory service is more likely to look at just a small part of the total financial requirements.

Goal setting becomes the central part of the financial planning process and all efforts are then directed towards meeting the goals. Overall goals might not be given too much importance in a normal financial advisory activity, where some specific target is sought to be achieved.

Financial planning looks to ensure that all the financial activities are not at cross purposes with each other. As against this, a typical financial advisory service might not even realise that some steps suggested would be working against some other goal or requirement. For example, financial planning would ensure that the asset allocation for an older individual meets their risk taking ability and that their equity exposure across asset classes is kept in check. This might not happen when normal advise is taken just for say equity mutual funds investment without knowing the equity exposure elsewhere.

Monitoring the situation and then taking action to ensure that things remain on track is a key part of the financial planning process. It is inbuilt to the entire effort, so this becomes a natural part of the activity. This might not happen with respect to a normal financial advisory where the individual might have to take the initiative themselves and see that things are going according to plan.

Financial planning looks to select what is right for an individual and this would differ from person to person. This takes into account both the returns as well as the risk which is vital. This might not happen for a normal financial advice, where the goal might be completely different like earning higher return and where risk might be ignored.

There has to be continuity in financial planning efforts which sets it apart from other financial advisory wherein this could be a short one-time exercise or even piecemeal efforts at different periods of time.

1.3 Scope of financial planning

Financial planning enables a household or individual to manage its personal finances efficiently in line with their short and long-term objectives. The following are elements of financial advisory and planning services:

1.3.1 Personal financial analysis:

- **Goal setting with prioritizing of goals**

The financial planning process starts with the goal setting process. Goals refer to what has to be achieved. This gives a clear target that has to be reached. There are several features that are important when the goals are set. There should be some specific detail with respect to the goal. For example, saying that I want to be rich is a vague term because it can mean different things to different people. Saying that I want to earn an income of Rs. 50 lakh a year is specific. The goals have to be measurable, so that a person knows the exact amount that will help them reach the goal. At the same time the goals have to be realistic. If an individual is able to save around Rs 20,000 a month, then a goal which requires an investment of Rs 50,000 a month is not realistic. Finally, goals also have to be time bound so the individual has a clear idea of when they need to be reached. A goal of wanting to retire in 20 years with Rs 5 crore as corpus is clear because there is a time period attached to it which will help in planning to reach the goal.

Once all these features are considered in the goal setting process there will be a list of goals that will be available. However, every individual has restrictions in terms of the income earned and amount saved. This will require that the goals be ranked in order of priority. Important goals need to be put first. So, things like children's education and retirement should come in front of something like spending on a luxury car or other expense that does not create an asset. It is easy to look at short term needs but this can come at the cost of long term disruption of the goals. This is why there has to be priority to goals that improve the financial health of the individual. For example, there might be a large credit card outstanding and some extra income is earned by the individual. In such a situation, instead of spending the amount, it should be used to pay off the credit card debt. This might not add to an asset but it still improves the financial condition of the individual.

- **Focus on important goals**

Goals such as retirement and education of children are important financial goals for which adequate provision of funds have to be made. Long-term goals such as retirement often get lower priority for allocation of savings because it has time on its side. The urgent, shorter-term goals often get higher claim on the available savings. While this may be acceptable for shorter-term goals that are also important, such as accumulating funds for down payment on a home, it may not be right to prioritize consumption goals, such as holidays and large purchases, over long-term important goals. The delay in saving for such goals will affect the final corpus, since it loses the longer saving and earning benefits including that of compounding.

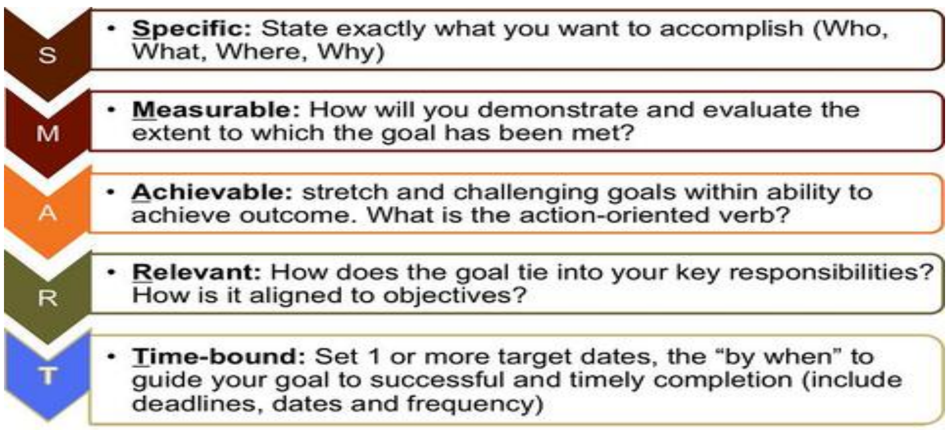
Clients often believe that the provident fund, superannuation and gratuity corpus they will receive on retirement will be adequate to ensure a comfortable living during the retirement years. In many cases, it turns out to be inadequate. Therefore, every client needs a retirement plan.

The Investment Adviser needs to go through the numbers and demonstrate the inadequacy. The objective is to ensure that the client saves enough during the earning years for a comfortable retired life.

- **Staggering the timing of certain goals**

The financial situation of an individual may not allow all the financial goals to be provided for. Some financial goals may have to be deferred to ensure that the critical financial goals are not compromised. There are situations when it is not possible to achieve a financial goal in a specific time period. An example could be a person wanting to buy a house within the next year, which would require a down payment of Rs 20 lakh plus an Equated Monthly Instalment (EMI) of Rs 30,000 a month. It could be that the current income situation is not able to support such a situation. Instead of cancelling the goal there is another route available. This is to push back the goal by some time, which will enable the individual to get the required finances in order. Instead of 1 year, if the goal is sought to be achieved after 3 years, then there is a good chance that the desired financial position will be achieved by then.

For instance, around the time that the family proposes to buy a house, the annual holiday may need to be reviewed. The holiday may be shorter or planned at a less expensive location. Some financial goals need to be fulfilled within a specified time frame. For instance, education of the child has to happen as per the normal age and progression. Prudent use of debt in the form of loans can be used to tide over any shortage of funds. The figure below helps an individual in visualising the parameters for setting personal goals.



1.3.2 Cash flow management and budgeting

There is a certain income that is earned by an individual along with the expenses made. Having a plan to ensure that there are savings and these are invested is one part of the process. It is also vital that there is a cash flow match so that the household or the individual does not run into any cash flow problems. This happens when the inflows and outflows of cash do not match. There can be a situation wherein a person spends less than what they earn but still run into cash flow problems. For example, if there is a large expense made at the start of a month it can lead to a cash crunch if there is a delay in the receipt of income unless there is a reserve present. In fact, it could lead to short term borrowings which are extremely costly in terms of interest rates. This could lead to a part of the amount that is being finally saved to be directed towards paying off the debt incurred due to the cash flow mismatch.

One of the ways to ensure that there is no cash flow problem is to have a budget with cash flow dates. A budget is nothing but a list of the inflows and outflows that an individual will witness along with the time period when this will take place. A monthly budget will help a person to know whether they are managing their income properly. A budget has a list of all the items of income and expenses along with their amounts. This ensures that with a single look it is possible to know what the exact financial position is and whether there is adequate savings taking place. Every person should make their own personal budget. A lot of people pay attention to the Union Budget but fail to do budgeting for their ownselves.

1.3.3 Insurance Planning

Several unexpected expenses that can cause an imbalance in the income and expenses of a household can be managed with insurance. Insurance is a risk transfer mechanism where a small premium payment can result in payments from the insurance company to tide over risks from unexpected events. The temporary loss of income from disabilities and permanent loss of income from death can be covered with life insurance products. Health and accident insurance covers help in dealing with unexpected events that can impair the income of a household, while increasing its expenses on health care and recuperation. General insurance can provide covers for loss and damage to property and other valuables from fire, theft and such events. Insurance planning involves estimating the losses to the household from unexpected events and choosing the right products and amounts to cover such losses.

1.3.4 Debt management and counselling

Investment Advisers help households plan their liabilities efficiently. It is common for households to borrow in order to fund their homes, cars and durables. Several households also use credit cards extensively. To borrow is to use tomorrow's income today. A portion of the future income has to be apportioned to repay the borrowings. This impacts the ability to save in future and in extreme cases can stress the ability to spend on essentials too. The asset being funded by borrowing may be an appreciating asset such as property, which is also capable of generating rental income. Or the loan could be funding a depreciating asset such as a car, which may require additional expenses on fuel and maintenance, but provide better lifestyle and commuting conveniences.

Evaluating which assets or expenses can be funded by borrowings is a function Investment Advisers can perform. They can advise households about how to finance their assets, how much to borrow, how to provide for repayment, how to ensure that credit scores are not unfavourably impacted. Sometimes, excessive borrowings may lead a household into a debt trap. Such borrowers need counselling and handholding to be able to get out of debt. Sometimes assets may have to be liquidated to pay off debts. Advisers help households to deal with their borrowings taking into account their need and ability to repay debt.

1.3.5 Investment Planning and Asset Allocation

A crucial component in financial planning and advisory is the funding of financial goals of a household. Investment planning involves estimating the ability of the household to save and choosing the right assets in which such saving should be invested. Investment planning considers the purpose, or financial goals for which money is being put aside. These goals can be short-term such as buying a car, taking a holiday, buying a gift, or funding a family ceremony or can be long-term such as education for the children, retirement for the income earners, or high-expense goals such as marriage of children. An Investment Adviser helps with a plan to save for these goals, and suggests an appropriate asset allocation to pursue.

The Investment Adviser does not focus on the selection of stocks or bonds, but instead takes a top-down approach of asset allocation. The focus is on how much money is invested in which particular asset class in order to deliver the expected return within the risk preference of the investor. The adviser's job is to construct a portfolio of asset classes, taking into account the goals, the savings, the required return, and the risk-taking ability of the investor. This is one of the core functions of the adviser and many specialise in asset allocation and investment planning.

1.3.6 Tax Planning

Income is subject to tax and the amount an individual can save, the return they earn on their investment and therefore the corpus they are able to build for their future goals, are all impacted by the tax regime they fall under. An investment adviser should be able to assess the impact of taxes on the finances of the individual and advice appropriate saving and investment options. The post-tax return of financial products will have to be considered while choosing products and estimating holding periods. The taxability of various types of investment income such as dividends, rents and interest differ. The treatment of return if accumulated, rather than paid out periodically, varies. The taxability of gains differs based on the holding period. An investment adviser should bring in these aspects while constructing a plan for the household. To be noted, tax efficiency should not be the basis of investment decisions, it is more about guidance and awareness. The basis should be the requirements and risk appetite.

1.3.7 Retirement Planning

Providing for retirement is one of the primary financial goals that all people have to plan for. Given its complexity and nature of well-being in the future, many people tend to ignore it until it may be too late thereby compromising the quality of their retirement. To be able to plan for retirement it is important to understand the concept of time value of money and inflation and how it would impact the cost of meeting expenses in the future. Saving and investing for retirement requires understanding of how compounding benefits investors saving for long-term goals. It is important to select the right financial products that are best suited to the long-term nature of the retirement goal as well as to the ability of the individual to take risks. In the pre-retirement stage, rebalancing the portfolio to less volatile assets is an important activity. As retirement approaches, the process of planning should shift focus to the expenses in retirement, the adequacy of the income from investments and pension benefits to meet these expenses and strategies to meet the shortfall, if any. While investing the retirement corpus for income, the taxability of different sources should be considered. The retirement portfolio has to be monitored and rebalanced through the term of retirement too since the needs do not remain the same. Investment Advisers bring the skills required to design and execute a retirement plan.

1.3.8 Estate Planning

Wealth is passed on across generations. This process of inter-generational transfer not only involves legal aspects with respect to entitlements under personal law, but also documentation and processes that will enable a smooth transition of wealth in a tax-efficient way. Estate planning refers to all those activities that are focused on transfer of wealth to heirs, charity, and other identified beneficiaries. There are several tools and structures to choose from, in estate planning. Some choices such as gifts can be exercised during one's lifetime, while choices such as wills come into play after death. Investment Advisers help households make these choices after considering all the implications, and help them complete the legal and documentation processes efficiently.

1.4 Concept of asset, liabilities and net worth

The income of a household or individual is at the base of all financial activities that are undertaken. The income is used to meet current expenses and a portion is set aside to meet expenses in the future. The portion of current income earmarked for future needs is called savings. The adequacy of the income of a household or individual is always relative to its expenses. If the expenses are managed within the income and there is surplus to save, then the household's or individual's finances are seen as stable. Short-term imbalances in income and expenses can be managed by loans and advances. The loans are a liability and come at a cost which may further strain the future income. The option of loans to fund expenses must be used with discretion since it weakens the financial situation of the household.

The savings of a household or individual are put to work by investing them in assets. Assets are broadly classified as physical assets and financial assets. Assets may be appreciating in value or depreciating. All assets have a resale value. Investors hold assets for the returns they provide. The nature of return that an asset provides classifies them as growth-oriented, income-oriented or a combination of the two.

Physical assets are tangible assets and include real estate, gold and other precious metals. Physical assets have an intrinsic value though the actual price at which they trade is impacted by demand and supply. They are usually seen as natural hedges against inflation since their price show a positive correlation with inflation. Physical assets are more growth investments that are bought for the appreciation in value rather than the income they generate. Some such as real estate provide both income and growth while others such as gold are pure growth-oriented assets. The primary drawbacks of physical assets are illiquidity, lack of regulation/limited regulation and the need for specific skills to identify investment opportunities, assess the merits of the investment, arrange for the purchase of the asset and its management and sale of the asset when required. The other limitation of physical assets as an investment is that they are typically large ticket investments and require substantial savings or a combination of savings and loan to acquire. When it comes to investment in physical assets, the adviser has to guide the investor, not to confuse consumption assets like car with physical investments, though the life a particular physical asset may be relatively long than other such assets.

Financial assets represent a claim that the investor has on benefits represented by the asset. For example, a bank deposit gives the benefit of periodic interest and repayment of principal amount to the holder of the asset, an equity share provides periodic dividend paid, if any, and the appreciation or depreciation in its value is also to the account of the holder. These assets may be structured as growth-oriented assets, such as equity investments, or as income-oriented, such as deposits, or a combination of the two, such as all listed securities. Financial assets are typically standardized products and controlled by the regulations in force at the point in time. They may differ on liquidity features, with some such as listed securities enjoying high liquidity, while others such as privately placed instruments featuring low liquidity. The standardization of financial assets and the mandatory information made available makes evaluation and comparisons more efficient. These assets lend themselves to investment in small amounts and units.

Together, the income / growth oriented physical and financial assets represent the investments made by the investor. While these assets represent financial benefits and returns to the holder, the financial strength of the household depends upon how the assets are acquired. Loans and borrowings used to buy assets create a liability and impose a repayment obligation on the buyer and a charge on the future income of the household. Loans taken to buy appreciating assets add to the long-term wealth. Loans taken to buy financial assets, also called leveraging, is risky because of the higher volatility in the price of such assets. Assets acquired with savings and without taking on a liability add to the financial strength of the household.

An assessment of the financial well-being of the household can be made by calculating the Net-worth. The net-worth is calculated as Assets – Liabilities. Higher this number better is the financial position of the household. Net-worth should be calculated periodically, and the progress tracked to bring the financial situation to the desired stage.

1.5 Financial Planning process

Financial planning requires Investment Advisers to follow a process that enables acquiring client data and working with the client to arrive at appropriate financial decisions and plans, within the context of the defined relationship between the planner and the client. The following is the six-step process that is used in the practice of financial planning.

a. **Establish and define the client-planner relationship:** The planning process begins when the client engages an Investment Adviser and describes the scope of work to be done and the terms on which it would be done.
b. **Gather client data, including goals:** The future needs of a client require clear definition in terms of how much money will be needed and when. This is the process of defining a financial goal.
c. **Analyse and evaluate financial status:** The current financial position of a client needs to be understood to make an assessment of income, expenses, assets and liabilities. The ability to save for a goal and choose appropriate investment vehicles depends on the current financial status.
d. **Develop and present financial planning recommendations:** The adviser makes an assessment of what is already there, and what is needed in the future and recommends a plan of action. This may include augmenting income, controlling expenses, reallocating assets, managing liabilities and following a saving and investment plan for the future.
e. **Implement the financial planning recommendations:** This involves executing the plan and completing the necessary procedure and paperwork for implementing the decisions taken with the client.

f. **Monitor the financial planning recommendations:** The financial situation of a client can change over time and the performance of the chosen investments may require review. An adviser monitors the plan to ensure it remains aligned to the goals and is working as planned and makes revisions as may be required.

1.6 Financial advisory and execution

Investment Advisers may engage with their clients at various levels and the scope of services they offer may vary depending on their skills, capabilities and business model. In several countries, including India, there has been regulatory action in defining the role of various intermediaries that deal with investors. When a relationship manager, financial adviser, wealth manager or other entity, irrespective of the nomenclature used, sells financial products to a client as part of his defined role or business, and earns a commission from the producer of the financial product, there is a potential conflict of interest. The seller of the product may not act in the interest of the client, but may push products that earn a higher commission. This may lead to mis-selling, where a product not suitable to the client’s needs, or not in line with the client’s risk preference may be sold in a manner harmful to the customer’s interest.

One of the regulatory initiatives to prevent such mis-selling is to differentiate between providers of advice and distributors of financial products, and to ask advisers to earn their revenue from the client, and not from the producer. The distributor who executes the transactions in financial products may earn a commission from the producer. The current regulatory regime for financial advisers in India requires that anyone offering financial advice for a consideration should be registered with SEBI, and should not earn any income from the producer. There are specific exemptions provided for those that offer advice incidental to a product they may sell.

The following are the various business models in the delivery of financial advice to clients:

a. Fee-only financial planners and advisers: Some Investment Advisers choose to earn a primary component of their income from enabling clients to plan their finances in a comprehensive manner. They engage closely with the client, offer advice on most if not all aspects of their personal finance, and charge a fee for their services. The fee may be of various types and a combination of the following:

- One-time fee for a financial plan
- Fee for on-going review and periodic revisions
- Asset-based fee charged as a percentage of assets being advised
- Referral fee for engaging experts to take care of specific aspects of the plan
- Referral fee for execution of plan through other agencies

- Selection and portfolio construction fees
- Fees for assessment and analysis of financial position

Fee only Investment Advisers usually do not take on the execution of the plan or advice. They refer the client to other agencies who may enable execution of the recommended investment transactions. This is to ensure that the commissions earned on selling financial products, does not influence their advice to their clients.

Under the amendments to the Investment Adviser Regulations, SEBI has said that individual Investment advisers cannot undertake both advisory and distribution. They have the choice to register as either of the two. A non-individual investment adviser will have client level segregation at the group level for these services. It also has to maintain an arm's length relationship by providing the advisory services through a separate division or department.

Individual Investment advisers are allowed to provide execution services but through direct schemes or products in the securities market. However, no consideration can be received at the investment advisers group or family level for these services.

b. Execution only services: Some Investment Advisers do not charge their clients for advice as their core function is distributing financial products. Their income comes from the commissions from selling the product. They may also execute transactions advised by another financial adviser. Such advisers may also distribute a range of products including investment products, insurance products, banking and loan products, which are subject to regulations by multiple regulators apart from SEBI.

Some firms may organise the execution only services into an aggregation model. The aggregating entity has several distributors associated with it, who take a range of financial products to clients. In this case, the company shortlists the products it would offer, based on its selection criteria. It may also have a central advisory team that selects products after research and data analysis. Those that like to offer these products to their clients, may associate with such company, and share their revenue with the company for using their research services, or execution platforms. Many aggregators offer a range of support services to their associates, including training, development, customer relationship management software, execution platforms and facilities that may be expensive to set up on a standalone basis. The shared facility helps the distributors to scale up their business, and pay the aggregator a share of revenue for the benefits offered.

c. Wraps and Platforms: Wraps and platforms are technology-based advisory solutions that are standardised for execution. A client or an adviser associate with the platform, offers its financial products as model portfolios that investors can buy. Investment Advisers may also choose these platforms to execute transactions in standardised model portfolios. Clients can view how their portfolios are performing. Advisers can monitor and review the portfolios and holistically manage the money of clients across multiple products. Wraps and platforms may charge the client a fee and share this fee with the adviser who executes the transactions using it. They may also enable the adviser to access clients using their platforms, to sell financial advice to such clients, and charge a fee and share it with the platform provider.