Chapter : 4

THE PROCESS OF PERSONAL FINANCIAL PLANNING

CHAPTER 4

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4.1 Introduction

The key areas of Personal Financial Planning were delineated in Chapter 2. Briefly, these are:

1. Insurance
2. Capital Accumulation
3. Providing for retirement income
4. Minimizing taxes
5. Estate Planning

This chapter offers an overview of the process of financial planning with regard to the key areas above. It dwells on the operational aspects such as assessing one's financial condition, setting goals/designing plans within constraints and implementing these plans. Yet, certain macro-level dimensions which are critical to achieving success in personal finance – – notably the issue of asset allocation – – are also covered in this chapter.

The first step, inevitably, would be to assess one's financial condition and capacity. Quite clearly, setting goals which do not bear any relation to an individual's actual circumstances would be inherently unrealistic and hence meaningless. So, information must collected about a variety of aspects relating to an individual's financial profile. These relate to:

1. Insurance policies on life, health, etc.
2. Investments
3. Retirement benefits/funds provided
4. Tax situation - present and anticipated
5. Status of estate planning

In this review, two well-known statements come in handy : balance sheet and the income statement, as applied to individuals. These are briefly discussed below.

4.2 Assessing one's financial standing

As is the case with companies, the personal balance sheet reveals an individual's wealth at a certain point in time. The personal income statement, on the other hand, discloses an individual's financial performance, that is, whether he has managed his expenses within his income and produced a surplus. The contents of both statements provide vital inputs for the next stage, that is, preparation of financial plans. Therefore, a closer look at these statements is called for.

4.2.1 THE PERSONAL BALANCE SHEET

As succintly explained by Gitman, it "contains three basic account classifications: assets, liabilities and net worth."[1]

The term "Assets" normally refers to tangible items, whether they were acquired with one's own money or through borrowing. Leased items, however, are excluded. Gitman[2] suggests a classification of assets into what he terms as "Fundamental Assets" and "Investment Assets." According to him, the former are those routinely held by a family/individual for their utility. Examples include cash, savings deposits, housing, autos and personal property. Investment assets, as is explicit, are those which yield a return, such as shares, debentures, mutual funds, real estate and insurance. Gitman also suggests certain rules for valuation and inclusion of assets. These are :

1. The assets should appear in the balance sheet at current fair market value (which may differ from the purchase price).
2. Exclude assets taken on lease.
3. Include even those assets which are not fully paid for.

The term "Liabilities" refers to the debts of an individual/family. These obligations may be short-term or long-term as for example rent, insurance premium, medical bills, credit card dues, overdrafts, car and housing loans. Generally, short-term loans relate to services or consumables acquired while long-term obligations are incurred to create fixed assets. For liabilities too, some rules for inclusion/classification need to be spelt out. These are:

1. All dues must be shown, even in the event of non-receipt of bills.

2. For the long-term loans especially, only the outstanding amounts ought to be shown.

The Net Worth is the excess of Total Assets over Total Liabilities. It is an indicator of an individual's wealth, which ideally should steadily increase with the passage of time. In fact, Net Worth is, therefore, a useful target in financial planning and monitoring. It is not the objective here to go into further details as regards the balance sheet, except to show a general format.

EXHIBIT 4.1

BALANCE SHEET FOR MR. STRANGER

(Year end March 31, 199X)

Liabilities and Net Worth		Assets	
Liabilities		**Fundamental Assets**	
Bills outstanding	Rs....	Cash	Rs....
Credit card charges		Savings Deposits	
Utilities bills		Housing	
Taxes		Vehicles	
...		Personal Property	
Instalment Loan Balances		Jewellery	
Car/Scooter Loan		Clothing	
...		...	
Housing Loan		**Investment Assets**	
Personal Loan		Shares	
		Debentures	
Net Worth		...	
...		...	
Total Liabilities and Net Worth		**Total Assets**	

From the above balance sheet, the figure of savings deposits indicates the individual's capacity to tackle deficits that may arise in future months. This is explained later.

4.2.2 THE INCOME STATEMENT

This is a statement of financial flows that occur during a definite period, which is generally one year. Its utility is two-fold. A review of past years' income statements gives a realistic picture of an individual's ability and capacity to generate savings, that is, to produce a surplus of income over expenditure. In this way, it facilitates realistic goal-setting. Secondly, the format is useful in the exercise of budgeting.

The statement comprises three key elements: Income, Expenditure and the surplus, i.e., contribution to savings or investments. Gitman[3] has provided a net break-up of items that would figure under Income and Expenditures.

EXHIBIT 4.2

SOURCES OF INCOME

Wages and Salaries

Bonuses and Commissions

Interest Received

(From savings, investments and loans)

Proceeds from Sale of Assets

Gains and Losses on the Sale of Securities

Other items

Rent Received

Tax refunds

Pension or Annuity Income

Miscellaneous Income

Gitman[4] has also suggested a few rules that need to be followed in aggregating the figures. For instance, only actual receipts should be shown in the statement. As for the proceeds from the sale of assets, they may relate to transactions involving a car or even furniture.

The categories of expenditures and the items therein are more numerous and detailed. They are (with modifications) as follows :

EXHIBIT 4.3

STATEMENT OF EXPENDITURES

Housing
- Housing Loan
- Rent
- Repairs and Additions
- Household Services

Utilities/Services
- Gas and Electricity
- Telephone
- Cable T.V.
- Water and other cesses
- Society charges
- (garbage, security etc.)
- Salaries to maid/cook

Food
- Groceries
- Vegetables
- Milk
- Eating out

Vehicles
- Purchase or Loan payment
- Petrol and oil
- Repairs and replacements
- License Fees/Registration

Taxes
- Property
- Income

Appliances, Furniture or Other Assets
- Purchases
- Instalment Payments
- Repairs and Maintenance
- Home Accessories

Health and Hygiene
- Cosmetics
- Laundry
- Disinfectants and Insecticides
- Cleaning Agents
- Barber and Hairdresser

Recreation and Entertainment
- Films/Plays/Circus
- Visits to gardens/zoos
- Cigarettes and others
- Records and Tapes
- Vacation and Travel

Other items

Lease charges
Charges to cleaner

Medical
Drugs and medicine
Doctors' bills
Hospital bills
Dental care

Child care

Clothing, Shoes and Linen

School fees
Books and magazines
Tutions
Postage and stationery
Personal expenses
Gifts
Charity
Miscellaneous unclassified expenditure

Insurance
Life
Health
Vehicles
Others

It should easily be possible to improve upon or add to the categories listed above. In any case, the use of a format as shown above makes one comprehend fully, the numerous outlets through which income flows out. It also shows how easily one could miss out accounting for small items of expenditures when a schedule such as the one above is not used in itemizing expenditures.

As was the guideline with the Income Statement, the Statement of Expenditures would contain particulars of amounts actually paid out. In the case of assets acquired with partial credit, only the amount shelled out (i.e., margin money) figures as an expenditure. The amount of financing is reported as an expenditure when it is actually paid off.

The outcome of an individual's 'financial performance' is usually a surplus that contributes to savings or investments. In the improbable event of a deficit, the individual may meet it by drawing down savings or liquidating investments or even resorting to borrowing. As mentioned earlier, a surplus goes to increase Net Worth, whereas a deficit reduces it. This is so irrespective of how surpluses are used or how deficits are financed. In the foregoing description, the surplus has been alluded to as a residue of income after expenditures have been incurred. However, such a view does not fit into the proper notion of personal financial planning. As Griffeth[5] rightly suggests, savings must be a category in one's budget "just like phone and electricity." After all, "Money is the seed of money..." (from a quote of Jean Jacques Rousseau in Shanbag's[6] book).

When the balance sheet and income statement are prepared regularly, that is, year after year, an appraisal of the progress is facilitated. One can check, for example, whether one's net worth has been steadily rising and whether the yearly surpluses have kept ahead of inflation. One may also evaluate the mix of assets and liabilities and determine the desirable changes in their composition.

4.3 Financial Planning

Individuals go through distinct financial phases in their lives. This has been strikingly depicted by Meir Kohn[7] in a graph of what he calls 'The Life-Cycle Pattern of Saving.'

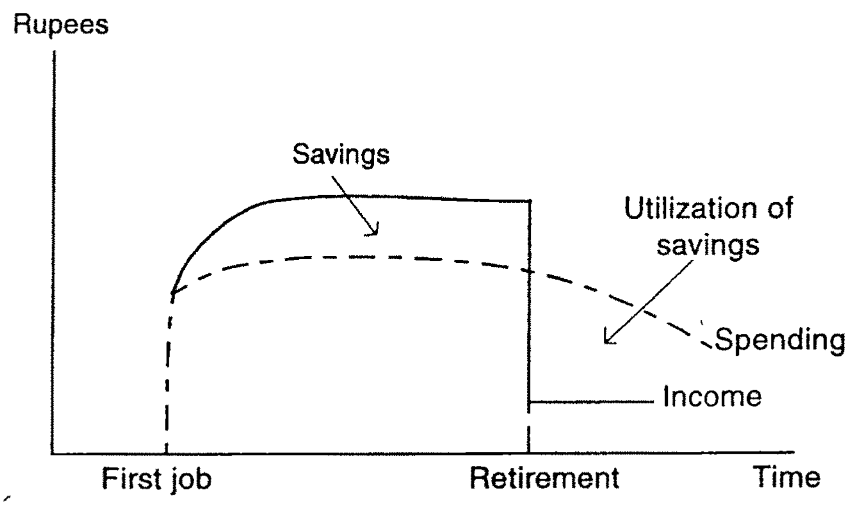

FIGURE 4.1

The Life-Cycle Pattern of Saving

The veracity of the above graph is more or less confirmed by statistics provided in Griffeth's book. Citing the results of a 1992 survey by the Bureau of Labor Statistics[8] in the U.S., he uses pie charts to reveal interesting data on saving. investment and expenditures, which are partly reported below :

TABLE 4.1

DATA ON SAVING, INVESTMENT AND EXPENDITURE IN THE U. S.

Age group (years)	As percentage of pre-tax income				
	Saving	Investment	Housing	Transport	Food
25 - 34	14	8	30	16	13
35 - 44	15	8	28	14	12
45 - 54	19	8	24	15	11
55 - 64	16	7	25	15	12
65 and beyond	2	2	32	15	16

Source : Griffeth, Bill, *10 Steps to Financial Prosperity*, 1st Indian ed., (New Delhi : S. Chand & Co., pp. 14-16.)

In the above statistics, what is most dramatic is the sharp fall in saving in the highest age group as contrasted with the younger groups. It is accompanied by a huge increase in the percentage of saving. Another interesting feature is that saving touches a peak in the age group 45-54, then shows a small decline before the steep plunge as mentioned above. Since the data relates to Americans, there are certain peculiarities, which may not be observed in India. For instance, the high (percentage) expenditure on housing in the highest age group must be largely on account of expenditure on retirement homes by the elderly. Nevertheless, the data generally corroborates the life-cycle pattern of saving. This emphasizes (if further emphasis was at all necessary) the need to undertake timely financial planning in an orderly fashion.

Financial Planning and Budgeting involves the following activities :

1. Establishing financial goals
2. Preparation of appropriate financial plans and budgets to achieve the goals
3. Constant monitoring accompanied by corrective measures to ensure that one stays on course.

1. The establishment of financial goals provides a direction and momentum to the process. The specification of long-term goals gives rise to short-term objectives which must be scrupulously met in order to cross the long-run milestones. In addition, there could be short-term targets that could also be planned for.

A simple but practically useful illustration of goal-setting is as follows :

EXHIBIT 4.4

LONG-TERM FINANCIAL GOALS[9]

GOAL	AMOUNT NEEDED	TIMING	SHORT-TERM OBJECTIVE
1. House	Rs.300,000*	10 years	Rs.1,090 p.m.
2. Retirement	?	30 years	?
3. Daughter's marriage	?	20 years	?

* Assumed to be the margin on a flat costing Rs.15 lac, 10 years hence. The monthly deposits cumulate at 15% per annum, compounded monthly.

In the above table, no amounts are shown for the other goals since these would need to be carefully worked out/decided upon individual considerations. In any case, retirement planning is dealt with in a later section, where the method for quantifying retirement goals is explained.

Short-term targets (unrelated) to long-term goals can also be defined in a similar fashion. An example is provided below:

EXHIBIT 4.5

SHORT-TERM FINANCIAL GOALS[9]

	Goal	Amount needed	Timing	Savings/ month
1.	Refrigerator	12,000	12 months	1,000
2.	Vacation	9,000	6 months	1,500
3.	Car Insurance	4,000	5 months	800

Even in the above instances, it may be possible to deposit the monthly savings in an interest-bearing account so that the required sum is cumulated at the required time with smaller monthly deposits. These days, the proliferation of consumer finance companies has made the acquisition of durables such as refrigerators, scooters, etc., much easier than it used to be some years ago. This development has rendered redundant, the need to plan and budget for the purchase of most durables.

The foregoing discussion offers a glimpse of the task of framing goals.

4.4 A Model Financial Plan

As a sequel to the foregoing, an illustrative model (which is sufficiently dynamic) that contains a comprehensive plan of goals and the means to achieve them, is presented in Exhibit 4.6.

EXHIBIT 4.6

THE ROAD MAP TO PERSONAL FINANCIAL SECURITY

Age (years)	Goals/Priorities	Vehicles/Instruments	Milestone
25 to 40 [Phase I : Modest but rising income]	1. Insurance on life, health and property	Mix of ULIP/Dhanraksha and insurance policies	
	2. Capital accumulation for housing (margin for loan)	a. Income Fund b. Blue-chip stocks c. High-quality debentures including FRBs and fixed deposits d. IVP/KVP	Acquisition of a house by the age of 40.
	3. Retirement Income	Provident Fund and/or PPF Account	
41 to 50 [Phase II : High income touching peak level]	1. Capital accumulation for anticipated expenditures, e.g., children's education, marriage, etc.	a. Growth stocks/funds and blue chips b. Deep Discount Bonds c. Convertibles d. Tax-free securities e. Real Assets e.g , silver utensils.	Accumulation of the desired amounts of savings for the purposes foreseen.
	2. Insurance	As in Phase I above (to include spouse and children also)	
	3. Retirement Planning	a. PF and/or PPF b. Retirement Benefit Plan	Steady growth in corpus started in Phase I
51 to 60 [Phase III : High Income]	1. Retirement Planning	a. PF b. NSC c. NSS	Receipt of PPF money from Phase I and/or Phase II.
	2. Capital Accumulation	Same as in Phase II	Expenditures incurred on education, marriage, etc , as foreseen.
	3. Estate Planning		Completion of unfinished formalities, if any, e.g , division of property/income, drawing up a will, etc.

The following points are noteworthy with respect to the above model.

1. There are three distinct phases, of which the first one stretches for 15 years, whereas the next two last for 10 years each. It is assumed that a typical person will start regular employment at the age of 25 and retire at 60 and so, the process of financial planning stretches over 35 years.

2. In each phase, the aspect of tax planning has been taken into consideration while suggesting the mix of investment vehicles. The composition anticipates a certain trend in income; in Phase I, the income is modest at the beginning and then rises gradually with the passage of time. Hence, comparatively less emphasis is placed on tax-saving devices in contrast to Phase II when income may touch peak levels. Accordingly, the composition changes in favour of stocks that will yield dividend income and capital gains, both qualifying for favourable tax treatment as also Deep Discount Bonds, tax-free securities etc. In Phase III, the accent is on tax shelters of shorter durations so that the maturity proceeds are received soon after or at retirement.

3. For individuals whose careers begin later, as for example, a doctor who sets up practice at say, 30 years the model can be suitably fine-tuned. In any case, the sequence of expenditures -- housing first, then children's education, marriage of daughter and lastly retirement -- is going to remain the same as also, very likely, the trend in income and hence the model remains relevant for a cross-section of individuals.

Other highlights of the model may be noted as follows:

4.4.1 PHASE I (P-I)

1. The priorities are clearly determined for each phase, and the emphasis changes according to the needs. For instance, in P-I, insurance and housing are accorded high priority, yet a beginning is made on

retirement planning.

2. Since the acquisition of a house is of paramount importance, the margin money is intended to be created from safer vehicles such as income funds (e.g. Units 1964 scheme) and high-quality debentures and fixed deposits. It is presumed that in the earlier years of one's working life, high current income from these vehicles, especially debentures, FDs and IVP/KVP will not aggravate his tax burden significantly. In fact, if such an eventuality is foreseen, the composition ought to be altered heavily in favour of shares, income funds, bank FDs and even PPF. Also, for faster capital accumulation, no time should be lost in reinvesting dividend and interest income as well as maturity proceeds of debentures, FDs and the like.

3. Income-tax shield is provided by insurance and/or ULIP/Dhanraksha as well as deposits into PF/PPF accounts.

4.4.2 PHASE II (P-II)

1. Capital Accumulation supersedes all else and a suitable mix of investment vehicles is suggested. With stocks, that is, blue chips and growth shares, the dividend income will be sheltered from taxes and the long-term capital gains on these vehicles will also receive favourable treatment. Deep Discount Bonds (DDBs) and tax-free securities also provide relief. The reason for suggesting silver utensils as opposed to gold is that "silver utensils used on ceremonial occasions if sold, would not result in any taxable capital gains."[10] And, since silver is used for industrial purposes, it may be a reasonably good bet, in itself.

2. The acquisition of the house in Phase I will yield substantial tax benefits on two counts: interest paid and instalments on the housing loan. These

benefits will spill over into P-II and help to offset partially at least, rising income from salary/profession/business.

3. With the passage of time, the need for insurance diminishes somewhat and hence it is ranked one notch lower than in P-I. Retirement planning continues steadfastly, and the avenues (viz., PF/PPF and Retirement Benefit Plan) produce additional tax savings through rebates.

   It is in this phase that the target amounts of savings for children's education, daughter's marriage and other purposes are fully or very nearly attained.

4.4.3 PHASE III (P-III)

1. Retirement Planning gets top slot, but the vehicles now recommended are shorter in term, e.g., National Savings Certificate and National Savings Scheme for the reasons mentioned earlier.

2. Capital accumulation for expenditures is de-emphasized since the tempo of savings and investment need not be maintained as before. It was mentioned in the preceeding section that the targeted level of savings are fully or nearly achieved.

3. Estate Planning is strongly recommended in P-III, and no later. In fact, the endeavour here should be to tie up loose ends, the implication being that Estate Planning may commence even prior to P-III. In any case, as pointed out in Chapter 2, elementary precautions in the nature of joint ownership of property, nomination of beneficiaries and so on should be taken very early on.

In the above model, the PPF account has been assigned the role of a sheet-anchor. It can serve a variety of purposes at different stages. For example, since an early opening of the PPF Account is recommended, it is quite possible that the accumulated savings may become available at the end of Phase I i.e., the commencement of Phase II. This inflow may help to partially or fully offset the outflow on account of a house, at that point in time. This money may either be rolled over or invested in shares, DDBs and others as recommended. The roll-over provisions are:[11]

1. At maturity, the PPF Account may be continued for intervals of five years independently.

2. In case the account is to be continued without further subscriptions, no formal intimation is necessary. In this situation, staggered withdrawals are permitted.

3. For continuing the account with subscription, formal communication in a prescribed form is necessary. Failure to notify will result in a non-entitlement to the benefits of rebate, although tax-free interest will be earned on the fresh contributions.

In view of such formalities, Shanbag is of the view that "at maturity, it is more advantageous to close the old account and start a new one rather than opt for post-maturity continuation." Yet such continuation for a block of five years may be desirable at the beginning of Phase III so that PPF proceeds that have grown over Phase II become available exactly at retirement. The alternative is, as stated earlier, to collect the balance at maturity, and use it for the objective of capital accumulation, which supersedes others in Phase II.

There are other significant features of the PPF account that provide enormous flexibility to an individual:

1. The minimum annual investment is only Rs.100 whereas the maximum is Rs.60,000. Hence, varying amounts of contributions from year to year are possible so as to suit financial ups and downs that one may

experience.

2. The facility of withdrawal from the seventh year may be tapped to meet contingencies or even to capitalize upon investment opportunities that may arise at certain times.

After the presentation of the model financial plan in the preceding pages, other aspects of budgeting are now examined in the paragraphs that follow.

4.5 Budgeting

As mentioned earlier, short-run objectives are derived from long-term goals by working backwards. The attainment of long-term goals is, therefore, dependent on an individual's ability to meet the short-term objectives. Thus, it becomes imperative to prepare budgets that would facilitate this process.

The budget preparation process involves three stages : Estimation of income, of expenditures and finalization of the budget. For arriving at these estimates, the formats presented earlier are useful. The estimates may span one year broken into monthly time intervals.

4.5.1 ESTIMATION OF INCOME

This would take into account, inflows from all sources such as salary, bonus and financial income. The endeavour here would be determine realistically, the level of income keeping in view likely increases (e.g., dearness allowances, pay hikes, and gains from other sources) as well as probable losses e.g., on securities transactions.

4.5.2 ESTIMATION OF EXPENDITURES

The more formidable task is to estimate expenditures, especially because of the probability of unforeseen expenditures as well as inflation that may cause outflows to swell beyond what was anticipated and provided for. As mentioned earlier, it is important that savings be given a high priority by including the desired sum as an item of expenditure. Moreover, any short-term contributions that are necessary to achieve established long-term goals must also be factored in as expenditure items. After drawing up the forecast of expenditures on a monthly interval, the total must be compared with the monthly estimates of income to ascertain if expenditures need to trimmed. This is possible in items such as, Eating out, Recreation and Entertainment and clothing and shoes. However, there is a limit to which expenditures can be pared. So, when the projections of monthwise income and expenditure are taken together, one may find surpluses showing up in some months and deficits in others. There are two ways of dealing with this situation in order to balance the budget.

1. Shift some expenditures from deficit to surplus months, or shift some incomes from surplus to deficit months.

2. When, even after adjustments as suggested above, some deficits and surpluses persist, recourse may be had to drawing down savings, liquidating investments or even borrowing funds for short periods to tide over deficits. What is critical here is to pinpoint the month in which the need for funds peaks, so that advance planning can be done. A simple illustration of such a Budget Summary using a hypothetical situation is shown below.

EXHIBIT 4.7

A MONTHLY BUDGET SUMMARY

Month	Estimated income (Rs.)	Estimated expenditure (Rs.)	Surplus (Deficit)	Cumulative Surplus (Deficit)
April	10,000	7,500	2,500	2,500
May	10,000	8,900	1,100	3,600
June	10,400	9,700	700	4,300
July	10,500	10,400	100	4,400
August	11,000	17,000	(6,000)	(1,600)
September	11,300	12,500	(1,200)	(2,800)
October	14,000	13,000	1,000	(1,800)
November	11,000	10,500	500	(1,300)
December	11,000	9,500	1,500	200
January	11,000	10,100	900	1,100
February	11,300	10,500	800	1,900
March	11,000	12,000	(1,000)	900

In the above example, the surplus or deficit is ascertained from the difference between estimated income and expenditure. However, it is the last column that calculates the surplus or deficit on a cumulative basis which helps to determine the pressure point i.e., the month of September when the cumulative deficit peaks to Rs.2,800. This alerts an individual into planning on how to meet this deficit. An obvious way is to draw on accumulated savings of previous years. Since, however, this may result in a loss of interest income, an alternative would be to seek an interest-free loan from a relative or friend for a short period. The eventual surplus for the year works out to Rs.900, which will augment the accumulated net worth. In fact, the aim of budgeting is to ensure that a surplus is produced which goes to ensure a comfortable lifestyle in future.

Gitman[12] further suggests the maintenance of accurate records and control procedures to ensure that actual expenditures conform to budgeted figures. When deficits appear more frequently or are of a bigger magnitude than forecast, a review and recast of the budget is indicated. Another simple though a somewhat inflexible and inconvenient approach is the system of placing budgeted amounts for different expenditures in separate designated envelopes. The expenditures for different items are made from the corresponding envelopes and if funds within an envelope are exhausted, then the period's spending for the specific item is stopped. At any time, the balances available for different items may be ascertained by counting the sums in different envelopes. Since this system is rigid, it may be more effective in ensuring performance according to the budget. However, it is inconvenient in that money, a fungible commodity, must be maintained in several different envelopes which must be opened separately for different expenditures. Moreover, the inflexibility of the system may, on occasions, impose spartan austerity on its users. A moot point is whether this system would pass the test of prudent cash management, since there may be an interest opportunity loss on account of cash being stuffed and maintained in different envelopes.

After the preceding introduction of the intricacies of setting goals and budgeting for financial success, the rest of this chapter throws light on the financial planning activities in each of the key areas, that were named at the outset.

4.6 Insurance

Insurance essentially provides protection against personal risks. As pointed out by Hallman and Rosenbloom, "these risks can arise from the possibility of premature death, disability, large medical expenses, loss of ... property from various perils, liability ... to others and unemployment."[13]

The idea of life insurance has universal appeal because of the 'Human Life Value Concept' of Late Professor S. S. Huebner. This concept centers on the productive capacity resting on knowledge and skills that an individual has acquired during the transition from childhood to adulthood. This productive capacity or Human Life Value (HLV) endows a monetary power by which an individual earns considerably more than what is needed for his self-maintenance and hence is of immense value to his dependents. The 1996 diary brought out by the Life Insurance Corporation of India defines HLV as "the capitalized value of that part of the earnings of the individual which are exclusively devoted to support persons (other than himself), who stand to benefit from his earning capacity." Thus, the answer to the question as to how much life insurance is needed lies in estimating the HLV, or in following the needs (programming) approach, explained by Hallman and Rosenbloom.[14]

4.6.1 HLV APPROACH

The endeavour is to estimate the economic worth of an individual to his dependents. This may be reckoned as "the loss of earnings devoted to an individual's dependents over his or her working lifetime, if the individual were to die today."[15] The following steps are involved in this exercise:

1. Estimate the individual's average annual earnings from future personal efforts over the remaining years of his productive lifetime. Ordinarily, this is the time span between his expected retirement age and present age.

2. Deduct the individual's personal living expenses and all insurance premia from his post-tax disposable income. The difference is the person's contribution towards maintaining his dependents.

3. As indicated above, ascertain the probable productive working period remaining.

4. Select a reasonable rate of interest at which the estimated future earnings (contribution to dependents) may be discounted. [The 1996 LIC diary suggests that this rate must take into account the expected yield on deposits with insurance companies apart from the rate of inflation.]

5. Multiply the amount of annual excess future earnings (explained above) by the present value interest factor (annuity) of Re.1 for the period of the remaining years of the person's productive lifetime, at the chosen discount rate.

To give a simple illustration, there is an executive aged 40, whose annual salary is Rs.144,000. For the sake of convenience, it is assumed that this salary will remain unchanged over his working life, and that Rs.120,000 is devoted to his family. With the given information, it is possible to calculate the executive's HLV by multiplying 120,000 by the present value interest factor of an annuity for 18 years at an interest rate of 15%. The underlying assumption is that he continues earning till the age of 58. The factor being 6.128, the HLV works out to Rs.735,360. In reality, the HLV will be higher since earnings will progressively rise with the passage of time both naturally and from inflation allowance. This is not taken into consideration whereas the interest rate of 15% is sufficiently realistic and can be assumed to contain an inflation premium.

In general, as an individual grows older, his HLV will decline so long as there are no changes in income, retirement age, taxes, personal living expenses, etc.

4.6.2 NEEDS (PROGRAMMING) APPROACH

Under the "needs" or "programming" approach, an effort is made to quantify the various funding requirements on account of different needs of a family in the event of the premature death of the breadwinner. Essentially, these would comprise the following:

1. Financial support for the surviving dependents to meet their basic minimum needs until the children grow up to become earning members. This period has been termed by Hallman and Rosenbloom[16] as the "dependency period" or "child-rearing period."

2. Special needs such as:

   a. Housing loan repayment sum
   b. Educational funds
   c. Marriage fund for daughter(s)
   d. Emergency fund

3. Life income for the widow for her remaining years.

The amount of life insurance required is ascertained by determining the uncovered deficit between the needs as mentioned above and the income or benefits expected from sources other than life insurance. An attempt is made to construct an illustration below for a hypothetical situation :

Husband	⇨	H, age 40
Wife	⇨	W, age 37
Son	⇨	S, age 8
Daughter	⇨	D, age 4

Lump-sum needs :

1. Housing loan repayment sum: Rs.250,000
2. Educational needs : Rs.120,000 (assuming four years of college for each child at Rs.15,000 per year individually)
3. Marriage fund for daughter: Rs.150,000
4. Emergency fund : Rs.50,000

Income needs : H desires that his family should receive the following monthly income to maintain itself if he were to die today.

1. Rs.8,000 per month until his son, S and daughter, D reach 22 (total of 18 years)

2. Thereafter, a life income of Rs.5,000 per month to his widow, who is expected to live till the age of 75.

The above mentioned income needs when discounted at an interest rate of 15% translate into the following lumpsum amounts at different points in time.

Today (Time 0)	18 years	38 years
596,262	379,711	

An amount of Rs.596,262 invested today would produce the desired income as mentioned in (1) above, and a corpus of Rs.379,711, 18 years hence would yield the income stream specified in (2) above. Discounted to today at 15%, Rs.379,711 reduces to Rs.30,683. Put together, the two add up to Rs.626,945. Hence, the sum total of the needs may be ascertained.

Housing Loan Repayment	250,000
Educational needs	120,000
Marriage fund	150,000
Emergency fund	50,000
Family income (rounded off)	627,000
	1,197,000

Against the above requirements, some resources may be available. An illustration is given below.

Group Life Insurance	100,000
Provident fund balance	100,000
PPF balance	100,000
Shares and other securities	150,000

	450,000

Thus, the difference between the two sums mentioned above which works out to Rs.747,000 is the amount of additional life insurance that is needed. Whether it is feasible, considering the income and the outgo on account of premium, is another matter. A way out is to seek a low-cost insurance policy initially (perhaps, a convertible term assurance policy) and then move to a permanent form of insurance.

Of the two approaches reviewed so far, the second approach seems superior as the needs are specifically stated and quantified, and hence it gives a truer picture of the financial position, i.e., the deficit or the amount of insurance that is ideally warranted.

4.6.3 INSURANCE MISCELLANCY

There are some other aspects to buying life insurance which an individual would do well to keep in mind :

1. "The first principle of insurance buying", as Hallman and Rosenbloom point out, "is to place primary emphasis on those risks that potentially could wipe out or substantially deplete the person's or family's net worth."[17] The determining factor is the severity of a potential loss and not its frequency. The authors have suggested the following measure to assess the magnitude of a potential loss.

$$\text{Relative value of a risk} = \frac{\text{Amount of possible loss}}{\text{Total Wealth}}$$

For example, if an individual's house is worth Rs.500,000 vis-a-vis his net worth of Rs.700,000, the relative value of his risk is five-seventh or slightly over 70%, surely too substantial a portion of his wealth, to be left uninsured !

2. The use of deductibles is advisable. A deductible requires that a policy holder pay a certain initial portion on a loss before the insurance money entitlement can commence.

Finally, it is noteworthy that full protection becomes available soon, even though premium payments span a long period. Moreover, there are no capital gains tax, gift tax nor estate duty on savings through insurance. Whereas life insurance provides financial protection from premature death, the other types of personal risks with enormous financial implications are the following.

1. Disability financial losses
2. Medical care expenses
3. Property and liability losses

Of the above, the first two get covered by LIC's policies or ULIP/ Dhanraksha and medical insurance. Property such as buildings, jewellery, domestic appliances, etc. are covered by householder's insurance policy while liability losses (e.g. doctor's indemnity insurance) are covered by different specific policies. It is not the objective here to go into details about these policies. Suffice to say that these must not be lost sight of in the course of financial planning as such an omission may prove to be very expensive. For example, medical care expenses in India have risen to exorbitant levels and must be guarded against. Before concluding, it is worthwhile to recall a few tips in the matter of insurance.[18]

1. An LIC policy over its entire term yields a low rate of return. However, the protection it offers is incomparable to any other investment vehicle. Rather than being a pure investment proposition, it is a contract that is multidimensional in nature. For example, a policy of Rs.1 lakh may be bought by payment of a nominal amount of premium. In the short or medium term, the premia constitute just a fraction of the contingent claim created by the policy. In contrast, an investment in equity shares would require an immediate outflow of Rs.1 lakh, with an attendant risk of capital loss due to price fluctuations.

2. Underinsurance can be foolhardy while overinsurance would cause an excessive cash outflow on premia.

3. Regular payment of premia is vital so as to avoid policies lapsing. All records must be carefully maintained for tax purposes as well as for settling claims.

4. Yasaswy also cautions against allowing policies to become paid-up. These are policies on which premia have been paid for three years but not thereafter. A paid-up policy loses entitlement to future bonuses.

5. One should be alert to the opportunity of collecting surrender value at the appropriate time. However, premature surrender is not advisable. To do so before the passage of two years would lead to a withdrawal of tax rebates and as a matter of fact, surrender value is nil if cessation of premia payments occurs inside three years. According to Shanbag[19], if a policy must be surrendered, then the best time to do it is after 5 years. However, the benefits of continuing with insurance versus those of surrendering and investing the proceeds in some high-yield securities need to be carefully evaluated. One option may be to seek a fresh policy

whose premia will be paid from the income from high-yield securities, so that some protection, albeit reduced, continues to be available. However, it is necessary to know the restrictions and rules in this regard.

4.6.4 BUYING THE RIGHT POLICY

Another important question that will confront an individual is : Which type of policy to choose ? It is somewhat difficult to give a straightforward answer since individual preferences, return, premia and other factors come into play. However, a review of the features of the leading types of policies may give some pointers on which might be the preferred type. The summary below is based on an article that appeared in a supplement of The Economic Times.[20]

EXHIBIT 4.8

A SNAPSHOT OF INSURANCE POLICIES

Endowment	Money-back	Whole Life
- Has a definite tenure - Premia are paid for a given period or till death, whichever is earlier. - At the end of the policy term, or at death, whichever comes first, the insured or his nominees receive the full amount assured, including bonus if any, tax-free.	- Has a definite tenure. - Premia are payable at specified intervals. - Bring in tax-free instalments after every four or five years (depending on the tenure) even while providing insurance cover for the duration of the policy	- The tenure is inordinately long. - The premia have to be paid till the age of 80, or till death, whichever is earlier. - It is the least expensive of all types and is pure insurance without any element of saving. The insured receives no payment since the (tax-free) sum goes to the nominees when he/she dies.

The article reported that LIC "sells more endowment and money-back policies rather than pure whole life insurance policy." The reason is that the endowment and money-back policies provide cash inflows, either a lumpsum benefit or in periodic instalments. The Whole Life policy brings neither to the insured, but only to his/her nominees. Still, the policy would appeal to individuals who want insurance at the most economical premium. Also, an interesting revelation in the article is that if on an average, life expectancy were placed at 65 years, the return on the whole life policy rises with the age of entry. For instance, for those buying the policy at 40 years and surviving till 65, the return to the beneficiaries turns out to be 7% on a profit sharing policy. But, if the entry age were to be 60 followed by death at 65, the return rises to 44%. So, apart from the cost of premium, another critical factor is the entry age for a Whole Life policy. All things considered, whatever be the type of policy, the return in general cannot even remotely match the yields elsewhere e.g., debentures. Hence, it may be a prudent strategy, to economize on premia by buying pure insurance in terms of a Whole Life policy so that the remaining savings can be channelled into high-yield securities, in order to achieve other objectives.

The other alternatives are endowment and money-back policies. Whereas the return on endowment policies is within the realm of LIC, the yield on a money-back policy depends on the rate of reinvestment of instalments (or survival benefits) received at fixed intervals. In another article[21], Sindhwani mentions that survival benefits could be placed into fixed deposits of finance companies or into open-ended mutual funds. However, since there would be tax implications on the returns earned, he suggests the alternative of deferring the receipt of the survival benefit after the due date, till whenever the policyholder needs it. For example, in Jeevan Sneha, a new money-back policy for women, Sindhwani mentions that LIC pays an interest of 11% per annum on benefits that accumulate with them. The advantage here is that one is freed from worrying about tax implications if sums are received from LIC.

Based on the foregoing assessment, an attempt is made to formulate a few guidelines. An individual may choose :

1. A Whole Life policy when his primary concern is to economize on premia. This will also make savings available for more attractive investments such as shares and debentures or PPF, if tax shelter is a consideration. Incidentally, a mutant of the Whole Life policy, the Limited Payment Life Policy has been specifically designed to help salaried individuals match their cash flows with premium payments since the conventional Whole Life policy may impose a strain during the retirement period on many.

2. If tax saving is the key concern, an endowment policy, with bigger tax benefits on higher premia and tax-free lumpsum benefits, may be considered.

3. If an individual is concerned about return, a money-back policy would help so long as the periodic benefits are prudently invested.

4. The choice of a policy may also be synchronized with the income levels of an individual. For example, when one begins a career on a modest income, a whole life or money-back policy may be preferred which could be supplemented or replaced by an endowment policy when income rises over a period of time.

5. One must always be open to the idea of combining ULIP or Dhanraksha that offer attractive returns along with basic insurance.

4.7 Capital Accumulation

4.7.1 OBJECTIVES OF CAPITAL ACCUMULATION

When explaining the Needs Approach, a mention was made of the emergency fund. Capital accumulation is pursued to achieve different aims, one of which is to create such a fund. This fund is to take care of unexpected expenses, that would not be provided for in the budget, as for example some emergency medical expenses or household repairs. This fund could be useful even to ride through a period of unemployment. As mentioned by Hallman and Rosenbloom[22], the size of the emergency fund can vary considerably and is governed by factors such as family income, number of income-earning members, assets, debts and other factors including a family's general attitude towards risk and security. A recommended size for the fund is between three to six months' family income, and that it should be placed in liquid assets, as for example savings accounts and short-term fixed deposits at banks. However, in India, people are loathe to leave so much money in a low-yield account. In fact, if it is possible to procure sufficient funds in an emergency, through other means then it does not make sense to maintain a huge emergency fund. Moreover, there are informal means by which funds can be raised in a contingency. These are loans from relatives or friends, loan against one's PF/PPF/fixed deposit accounts, Nidhis or the more expensive sources such as a money lender or a chit fund (also called 'Vissi') run in certain organizations by the employees.

The other aims of capital accumulation include the acquisition of a house, a corpus for children's education, the marriage of daughter(s), the creation of a retirement fund and of a general investment fund, the purchase of a new car and so on.

These objectives must be attained at different stages in one's working life. This can be shown by a simple diagram as under :

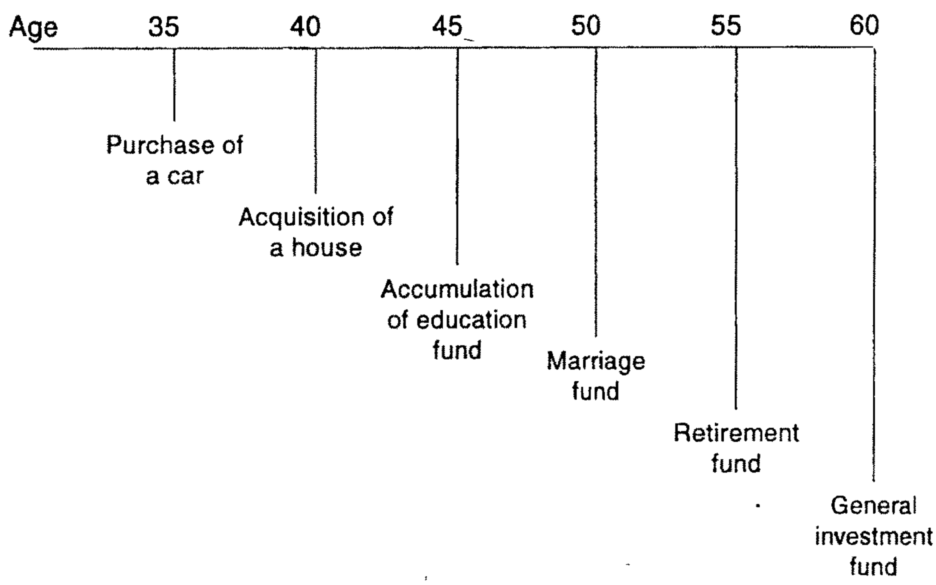

FIGURE 4.2

A Sequence of Financial Goals

The above diagram with minor modifications can form the basis of any individual's financial plan. For instance, the first aim viz., the purchase of a car can be suitably deferred or dispensed with altogether, or substituted by a scooter. Similarly, the education fund and the marriage fund could be preponed or postponed by a few years, depending on the individual's circumstances. So also, the creation of the general investment fund may be moved leftward, if such a fund is necessary in order to produce an additional income to supplement the main source. A dynamic financial plan that integrates the above-mentioned goals with a suitable mix of portfolios has already been presented earlier in this chapter.

The important point to be gleaned from the diagram is that most of the goals are distant milestones, but which nevertheless must be planned for.

The biggest unknown variable that one must contend with, when dealing with distant goals, is inflation. Take education for instance. Whereas there is virtually no uncertainty as regards the number and ages of children and when they shall enter college, trying to reckon the costs of education is a bewildering exercise. In India, higher education which is highly subsidized is expected to become an expensive affair as our Government tries to extricate itself from the throes of a financial crisis. The present generation is already witnessing the emergence of private or autonomous institutions in professional courses such as engineering and business management, where the fees are considerably higher than at public institutions. As land and construction costs spiral upwards along with the prices of laboratory equipments, new educational institutions will perforce charge higher fees. Rising real estate prices mean bad news for prospective home buyers as well, which further complicates the goal of capital accumulation. Therefore, an assumed rate of inflation has to be factored into such calculations. There can be no straight answers on how much to accumulate for housing, education and marriage. These decisions are mainly governed by personal preferences such as the type and location of the house, how much to spend on the daughter's marriage, etc.

Although there are specific investment vehicles to create a retirement fund, it is within an individual's discretion to build up capital in alternative ways to bolster or create the retirement fund. The size of such a fund depends on the amount that is expected to be saved through the primary vehicles, the desired corpus at retirement and the difference between the two, which will be the supplementary fund.

The general investment fund which would yield an increasing level of financial income (interest and dividends) with the passage of time, can serve a variety of ends. For one, it can, as mentioned previously, augment one's main source of income; it can also facilitate a higher standard of living in future, make premature retirement a feasible proposition, or make it possible to bequeath a handsome amount to the children.

The vehicles for capital accumulation include fixed-income and varible-income instruments which were reviewed in Chapter 2. Some points relating to the factors in the choice of investments such as safety of principal, liquidity and tax benefit were also examined briefly, therein. Importantly, capital accumulation must not be overtaken by inflation[23]. The chapter also contains the salient features of a portfolio approach to investing, especially in equity shares. Some more points in this context are discussed below.

4.7.2 THE INVESTMENTS PROCESS

Sharpe, Alexander and Bailey[24] have described a five-step procedure which comprises the investments process. These are :

1. Set investment policy
2. Perform security analysis
3. Construct a portfolio
4. Revise the portfolio
5. Evaluate the performance of the portfolio

The first step, that is framing the investment portfolio involves specifying an investor's goals and ascertaining the amount of investable funds. Earlier in this chapter, we have looked at illustrations of how goals could be set. One aspect of goal-setting that must not be overlooked is the specification of risk as well. For instance, a goal that has already been set may demand a very high target return on the investor, which may not be compatible with the desired level of risk. Supposing an investor wants his savings of Rs.10,000 to cumulate to Rs.30,000 in five years. A simple calculation reveals that the initial sum must grow at a compound rate of nearly 25% per year, in order to attain the goal. But, if the investor in question is a risk-averse individual who will confine himself to bank deposits, high-grade fixed deposits and gilt-edged debt instruments, then clearly a target return of 25% is unrealistic, and will need to be changed. Hence, goals must be commensurate with risk.

Specifying risk could be a somewhat tricky process. Oslen's exposition of the characteristics of investment risk highlights the complexity of this matter.[25] The risk profile of different investment vehicles may be shown by a simple diagram, as under:

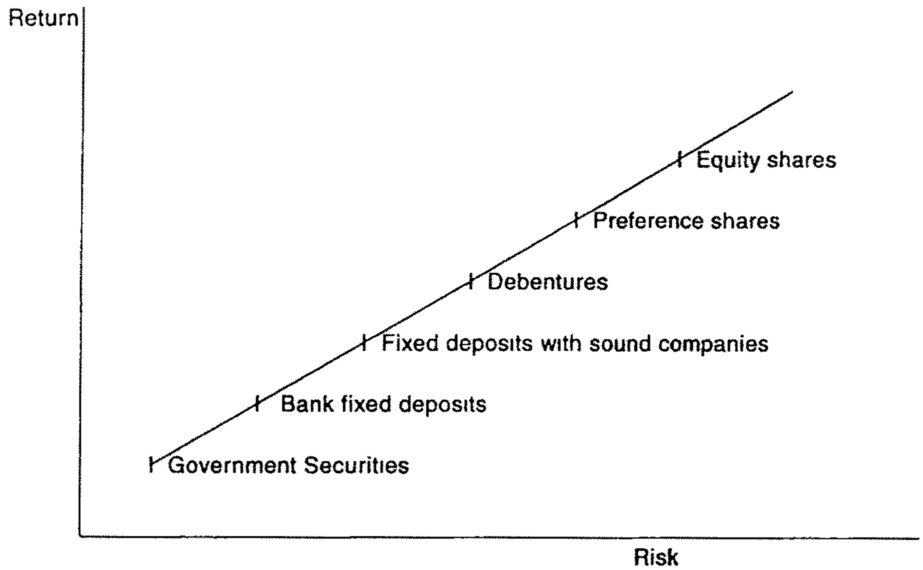

FIGURE 4.3

Risk Profile of Investment Vehicles

The diagram above does not attempt to show finer distinctions, as for example, within a class of vehicles (fixed deposits with different ratings would yield different returns). It is also possible that a high-grade debenture may yield less than a low-quality fixed deposit, which the above diagram does not reveal.

Though risk disposition is difficult to spell out, in the case of rated vehicles, one could specify the acceptable level of rating. This would cover company deposits, debentures whose maturities exceed 18 months, and even some equities since ICRA has begun the service of Equity Grading. Although ratings are available on money market instruments viz., Commercial Paper and Certificate of Deposit, these instruments are outside the reach of most individuals. But, progressively, ratings may become available on mutual funds, which would help further in specifying risk. So, for example, on fixed deposits, an investor may go down upto FA {(or MA or CARE A(FD)} whereas with debentures he may include all ratings qualifying for investment grade, i.e. upto BBB {or LBBB or CARE BBB}. For equity shares, another criterion could be the beta co-efficient, wherever available. Besides what is mentioned above, the investor must also bear in mind, the marketability risk in choosing securities for his portfolio.

Yet another dimension to risk is that an investor may adopt different postures with respect to risk as goals differ. This point has been illustrated in the model proposed earlier in this chapter. Since housing is deemed to be too important a goal to toy with, the investment vehicles suggested for accumulating the margin amount in Phase I are income funds, blue-chip stocks, etc., so that the target is not jeopardized. This is in contrast to the portfolio for capital accumulation in Phase II which clearly reflects a more relaxed stance towards risk. When the purchase of a house is the goal, timing is of the essence since it secures both location and cost. However, with goals such as an education fund or marriage fund, there is some leeway with regard to cost and timing, which therefore allows flexibility in the composition of one's portfolio.

The second rung in the five-step procedure is security analysis, by which individual securities are examined in order to identify those that are mispriced. A summary of the two major approaches viz., Fundamental Analysis and Technical Analysis has already been presented in Chapter 2 of this thesis, and hence needs no repetition.

Next comes portfolio construction. Sharpe[26] et al., have highlighted that at this juncture, the issues of selectivity, timing and diversification need to be addressed by the investor. Selectivity relates to the price movements of individual securities, whereas timing pertains to the forecast of price movements of equity shares as a group as contrasted with fixed-income bonds in general. Diversification implies a combination of different assets in suitable proportions so as to reduce risk.[27] This brings up a very critical point -- that of asset allocation. An article[28] has emphasized the point that "the most fundamental decision in investing is not individual stock or bond selection (though it's very important) but that of asset allocation." Citing unspecified academic studies it mentions that over 90% of the difference in the long-term performance of the U.S. institutional investors is attributable to their original asset allocation decisions rather than to what the fund managers did within each category. The lesson that emerges is that the key to long-term success in capital accumulation is in determining the allocation of investable funds between equities, bonds and cash and not in the selection of particular securities. The explanation to this is that at different points in time, one homogeneous class of assets (say, bonds) may be poised for a better performance than another (e.g., equity shares), over a certain time period into the future. Therefore, the more important task is to identify the preferred class and allocate more funds to that set of securities. This is supported by Brinson[29], et al. This dimension about the need to forecast relative performances implies that poor timing can negate skillful stock selection. The article[30] quotes Warren Buffet : "Should the stock market advance to considerably higher levels, our ability to utilize capital effectively in (equities) will be reduced or eliminated. This will happen periodically; ...."

A simple example in the Indian context makes this point quite effectively. On February 21, 1997, the BSE National Index closed at 1498.1 as against a level of 1594.2, a year before (February 20, 1996).[31] This amounts to a decline of 6%. If someone had foreseen the liquidity crunch, economic slowdown and the political skulduggery which seemingly explain this dismal stock market performance, it would have been crystal clear to him or her to allocate funds in the first place to alternative assets such as fixed deposits or bonds. No doubt, one could argue that a handpicked portfolio of equity shares (instead of the BSE National Index) would have outperformed fixed deposits and bonds. But with what confidence can one assert this contention ? When the stock market in general is set for a descent, equity selection becomes even more onerous. Why not, therefore, seek refuge in the more assuring bond market or even fixed deposits ? Alternatively, one could even increase cash holdings to an extent, and reorder the portfolio suitably at an appropriate time in the future. In sum, the point is that diversification across asset classes with suitable changes in the mix in tune with anticipated relative performance must be the overriding priority.

Apart from the anticipated relative performance which may cause the portfolio to be reordered at certain points in time, investment objectives and age too are factors which may influence asset allocation. In so far as investment objectives are concerned, examples have been given earlier in the context of risk specification e.g., housing versus a marriage fund. As for the age factor, a conservative investor may decide to progressively allocate more funds to bonds with the passage of time. The article[32] cites a rule of thumb offered by a leading investor, John Bogle : the bond portion of an investor's total investment portfolio should be roughly equal to his age. That is, a thirty-year old must have 30% of his portfolio in bonds, and the rest in stocks. At the age of 50, the composition must be 50:50, and at the age of 65, the bond portion should have risen to 65%. It is discernible that the underlying consideration for these changes is risk. Therefore, in view of the foregoing discussion, the questions that an investor must ask himself are :

1. What is the goal for which capital accumulation is being pursued ?

2. Should asset allocation be governed by considerations of return or of safety ?

Sharpe, Alexander and Bailey[33] have dealt with these issues. However, while their treatment of the topic would clear the test of academic rigour, a layman may find it difficult to apply their conceptual approach. At the outset, in framing investment policy (i.e., the first of the five steps), they suggest making an estimation of the level of risk tolerance of an investor. This refers to the maximum amount of risk that the investor is willing to bear for a given increase in expected return. Next comes the task of security analysis followed by portfolio construction. Here, the authors suggest that forecasts be made of the expected return, standard deviations and covariances for all equity shares under consideration and a similar exercise be done for bonds as, it is assumed that a combination of these two asset classes will comprise the total portfolio of the investor. These calculations will produce efficient sets for both asset classes, and it will become possible to identify the respective optimal portfolios. This leads to the asset allocation decision. Here again, a series of calculations are entailed. The expected return and standard deviation are to be determined for all combinations of the two portfolios. (This itself calls for fresh statistical inputs such as the expected return and standard deviation for both the optimal stock portfolio and the optimal bond portfolio, along with the covariance between the two portfolios). Eventually, the efficient set of the combinations is generated and the preferred mix is identified with the help of the investor's indifference curves.

Of more practical value however, are their suggestions[34] regarding "strategic asset allocation" and "tactical asset allocation." The former pertains to the long term whereas the latter is concerned with responses to short-term market conditions. The composition under strategic asset allocation would be a long-term commitment from which deviations would be temporary in tune with short-term market conditions. Such an approach could be adopted in all instances of capital accumulation programmes, irrespective of the goals or age considerations. However, changes in the mix will have to be effected at the right times, i.e., soon after new trends have emerged in the different asset markets. For example, if the strategic asset allocation has been pegged at 80:20 between stocks and bonds, the response in the event of downturn in the stock market should be quick; i.e., the mix must be altered swiftly in favour of bonds so as to avoid capital losses on equities in the portfolio. Similarly, when an upturn comes, the investor must be quick to restore the original composition so that profits can be maximized. However, it is left to the investor to decide whether and to what extent, he would wish to keep effecting changes in the composition as discussed above. It must be remembered that such changes may entail substantial transaction costs.

Another issue referred to by the authors[35] is that of sector (or, group) selection within each asset class. Sectors could be conveniently categorized as industrials, utilities or transportation into which all stocks under consideration could be appropriately placed. Likewise for bonds where the sectors would be long-term, intermediate-term and short-term. The next step would be to identify the optimal portfolios for each of the six sectors, in both asset classes. Thereafter, a suitable combination of sectors under each asset class could be chosen. An alternative approach in sector categorization would be to classify stocks as being either blue chip, growth, speculative or defensive in nature. These terms were explained earlier and they connote risk and return prospects. Optionally, bonds, too may be classified as gilt-edged, investment grade (besides those gilt-edged), and speculative grade. When stocks and bonds are classified in this alternative fashion, the task of constructing portfolios that incorporate the risk and return preferences of investors is comparatively easier. To illustrate, if a stock portfolio comprises 60% industrials, 30% utilities and 10% transportation equities, it remains unclear as to whether it is growth-oriented or speculative or defensive, etc. But, instead, if the composition was 60% growth stocks, 30% in blue chips and 10% in speculative shares, the profile is quite clear. By the same logic, a bond portfolio that has 10% in gilt-edged securities, 50% in other investment grade bonds and 40% in speculative securities indicates a fairly aggressive posture on the part of the investor presumably to earn a higher yield.

There are, however, two drawbacks with the alternative approach. Firstly, classifying a stock as a growth share, blue chip, speculative, etc., is a formidable challenge since it requires much more information about the company, industry, demand projections, etc. In contrast, categorizing it under industrials or utilities or transportation is considerably easier. Moreover, in several cases, the dividing line between a growth share and a blue chip may be blurred. Secondly, if bonds are classified as gilt-edged, speculative grade, etc., instead of in terms of maturity, it would become more difficult to gauge the interest rate risk as the maturity profile would be unclear.

Yet, based on the foregoing assessment it is desirable that stocks be categorized by type (i.e., whether blue chip or growth etc.) or the categorization suggested by Peter Lynch[36] notwithstanding the practical difficulties and bonds ought to be categorized by maturity. In the latter case, since ratings would be available in most cases, the risk factor can be taken care of in selecting the bond portfolio.

It is on the basis of an in-depth assessment of a company's products, trends and stability of sales and profit margins, forecasted market share, stage in the industry/company life cycle and a host of other factors culminating in an estimation of the future earning power, that its equity share can be labelled as a growth stock or blue chip or any other. Generally, what many investors would seek are plum investments in a growth industry; yet, occasionally, one may find a growing company (i.e. expanding market share) in an otherwise stagnant industry.

Portfolio revision is another important activity in managing one's investments. It is necessitated when a currently held portfolio is viewed as being suboptimal and in need of a change. An obvious implication of portfolio revision is the incurrence of transaction costs. These include brokerage and bid-ask spreads. Besides, there may be tax implications as well. In any case, a portfolio revision is undertaken with the expectation or belief that the gains that will accrue from the changes will significantly outweigh the transaction costs.

The decision to sell securities held is as important if not more than the decision to buy and is, arguably, more exasperating than the buy decisions. But, securities, once bought, ought to be sold since "the only way to end the game profitably is to sell."[37] This applies even to stocks held for the long-term since a sale is necessary to capture capital gains. The stock markets have their cycles so even good stocks which are sold at or near the peak could be re-acquired later, at or near the trough, if so desired by the investor. Cassidy[38] has lucidly laid bare some reasons why investors balk at the sale decision. One such reason is commission phobia, that is, the incurrence of brokerage on transactions. Commissions, are inevitable, like taxes, so they ought to be built into the calculations anyway, at the time of purchase. Being hung up about brokerage can sometimes impose substantial opportunity costs. For instance, a reluctance to sell a dull stock merely to postpone the incurrence of brokerage prevents the investor from taking a position in an alternative stock that may perform better. Another obstacle can be oversensitivity to the tax implications of a sale. A research study[39] appears to corroborate this. It is not possible to want a profit and yet wish away tax thereon ! The urge to postpone taxes must not come in the way of rational investment action. A thought-provoking statement that Cassidy makes is : "The best of all tax situations is to incur huge tax obligations, which accrue only from earning an extremely large income."[40] Further, he bolsters his arguments by stating that "the amount of profit desired before or after tax on a given stock position is irrelevant. The amount of profit realistically allowed by the market is a better criterion for timing a sale."[41]

Some of this advice may appear to be at odds with what Buffet has argued, as explained in Chapter 2. However, that would be an incorrect interpretation. A proper meaning of Cassidy's advice would be that if the time has come to sell off a stock, tax considerations should not impede this action. In fact, he says in a forthright manner that shares should continue to be held when market and company prospects appear bright[42]. In later chapters, Cassidy discusses some common failings of investors. One of these is to be hung up about the cost price, and thus be unable to execute the sale. He terms the cost price as "psychological baggage of great personal magnitude" whose "effect is detrimental to the eventual execution of a successful sale."[43] The definition of a successful sale, according to Cassidy, is not limited to one that produces a profit, but it also includes that which averts or minimizes a loss. He emphasizes the vital point that "a good price or time at which to sell a stock is defined by what happens to the stock after the sale occurs, and has nothing to do with the prior event (investor purchase)."[44] The few exceptions, when cost price may matter are instances when the particular cost price may be viewed at large as significant – as for example, the par value when shares have been issued to thousands of investors at par.

The points discussed in the preceding paragraphs provide a glimpse of the nuances of a sale decision. Clearly, selling is a discipline that needs to be imbibed thoroughly by any individual wanting to be successful in investing. For effective portfolio revision, selling is vital and inevitable.

Periodic monitoring of one's portfolio is necessary in order to check whether steady progress is being made towards the long-term goal. It is, therefore, essential that an investor be familiar with measures of performance such as the Holding Period Yield (HPY) on a post-tax basis for equity shares, bonds and mutual funds. Computing the HPY periodically alerts an investor to poor (or less than expected) performance by any of his investments, and leads him to determine whether the underperforming vehicle(s) must be replaced by more attractive opportunities.

Aside from comparing the actual HPY vis-a-vis the required rate, an elementary benchmark for risky investments is the return from risk-free securities issued by the Government. As Gitman states the axiom : "If one's risky investments failed to outperform low-risk investments, a careful examination of the investment strategy is in order."[45]

Yet another simple yardstick for deciding on whether a particular investment vehicle is worthwhile holding is to pose the question : Would I buy it if I did not already have it in my portfolio ? A negative answer implies that the vehicle in question should be sold ! Gitman also suggests a measure called the Risk-adjusted Market-adjusted Rate of Return. But this involves the use of the beta co-efficient of shares which may not be readily available in India.

4.8 Providing for retirement income

A very important maxim in ensuring an adequate retirement income is to start early. Moreover, by doing so, there is no burden of having to set aside large amounts, as even small sums saved accumulate to a handsome corpus over a long period, essentially because interest is compounded. In the suggested financial planning model, it was recommended that retirement planning should commence in Phase I itself, starting from the age of 25. Later in the chapter, in the section on capital accumulation, it was shown in a simple diagram that among other objectives, the retirement fund ought to be built up by the age of 55. Hence, a time span of 30 years is provided for. The following table shows how small amounts of savings over a long period accomplish wonders through the power of compounding. The interest rate selected is a reasonable 12% per annum.

TABLE 4.2

THE POWER OF COMPOUNDING

Amound saved	Corpus in 30 years (Rs.)
Re.1 daily (i.e. Rs.365 every year)	88,086.43
Rs.2	176,172.85
Rs.3	264,259.29
Rs.4	352,345.72
Rs.5	440,432.15
Rs.10	880,864.30
Rs.15	1,321,296.45
Rs.20	1,761,728.60

A saving of Rs.20 per day means an annual saving of Rs.7,300 which is not an onerous burden for someone even at the start of his career. Griffeth mentions about surveys which reveal "that most people save for retirement the way they used to study for final exams. They wait until the last minute."[46] Therefore, the earlier one starts saving for retirement, the less will be the pressure on his monthly income over time.

The crux of the issue, as in the case of insurance, is to determine the amount to be set aside at regular intervals for the retirement fund. There are two critical variables which may throw a spanner in the works : inflation and return on accumulated savings. Inflation would gradually raise the cost of living which implies that the retirement corpus will need to be bigger than otherwise. On the other hand, if inflation remains low or moderate thus contributing to a decline in interest rates over time, the yield on accumulated savings may also decline. Such a phenomenon too has to be taken into consideration, when planning for retirement income. Another aspect is the degree of risk that may be assumed in investing retirement money. Just as it would be imprudent to take on too much risk, extreme conservatism may yield only nominal returns.

The sum of money to be set aside periodically can be ascertained by first quantifying the long-term goal ahead and then working backwards to figure out the short-term objectives. An illustration is shown below.

Supposing an investor aged 40 with 20 years remaining to retirement already has Rs.200,000 saved in his retirement fund. At a compound interest of 12% per annum, this amount will cumulate to a little over Rs.19.29 lakh in twenty years. The investor's current income is Rs.12,000 and he expects that his retirement needs will be less, i.e., at 70% (this is a handy rule of thumb). At today's income, it works out to Rs.8,400. However, if inflation were assumed at 9% per annum, the equivalent of Rs.8,400, twenty years hence works out to Rs.47,077 per month or Rs.564,924 annually. This would require a corpus of Rs.4,707,700 yielding 12%, that is Rs.564,924. As noted earlier, current savings are expected to grow to Rs.19.29 lakh, whereas the long-term goal is Rs.47.08 lakh. Therefore, there remains a gap of Rs.(47.08 - 19.29) lakh, i.e., Rs.27.79 lakh to be covered. This gap can be bridged by putting away Rs.38,659 every year for 20 years in an account that compounds interest at 12% per annum. The answer is arrived at by dividing 27.79 lakh by the compound value interest factor for an annuity, which in this case is 72.052. The above example is based on a magazine article[47] which also suggests refinements to cover post-retirement inflation as well. This is a case of a self-constructed retirement plan. There are other avenues which may be used either concurrently or alternatively to a self-constructed plan. These include, as seen earlier, the provident fund, employees pension plan, PPF, Jeevan Dhara/Jeevan Akshay, or a plan such as that offered by UTI or LIC. The model financial plan presented earlier in this chapter suggests a combination of PF and PPF, with additional vehicles, at a later stage, viz., the Retirement Benefit Plan and NSC and NSS as well. The reasons for the particular choice of vehicles in the order suggested, are also explained.

4.9 Minimizing taxes

The previous chapter was devoted to the different tax-saving schemes and strategies, with respect to current income, capital gains and other situations. These techniques are intended to achieve the following objectives:

1. Tax reduction or elimination
2. Deferring taxes
3. Shielding current income in order to allow capital accumulation
4. Influencing the form in which income is received so as to have a lower tax

burden

A reference to the model financial plan shows that the above objectives have been kept in mind while suggesting specific investment vehicles to cross different milestones. The explanation following the model elaborates this point. For example, the profile of the investment portfolio undergoes a significant change from Phase I to Phase II, in order to reduce taxes on current income, take returns in the form of capital gains, etc. It may be appropriate, at this stage, to bear in mind, the point stressed by Hallman and Rosenbloom. While acknowledging that tax planning is important, for it can produce savings, they urge caution against overemphazing it, since this may "result in unwise or uneconomical transactions."[48] Accordingly they offer some tax-planning caveats such as the following:

1. Tax factors ought not to outweigh other important objectives.

   An instance that fits this situation is the case discussed earlier -- the diffidence on the part of an investor to sell an appreciated stock primarily on account of the tax implications.

2. Understand the sacrifice involved in exchange for the tax saving.

   The authors point out that almost any tax-saving proposition will involve some loss of flexibility, control or an advantage that might have remained otherwise. For instance, on a purchase of NSCs, the investor parts with some money for six years. Similarly, a motivation to minimize taxable current income may impel some individuals to invest in bank deposits or equity shares rather than debentures. Clearly, in one alternative a sacrifice in return is entailed while in the other, a greater risk is conspicuous.

3. The tax saving must be significant enought to justify a transaction.

   A situation of this type was examined in the previous chapter under strategies to minimize taxes on capital gains. A decision to extend the holding period on equity shares so as to realize long-term capital gains must result in an adequate amount of tax saving.

4. Retain flexibility in one's financial plans.

   This is to take care of changing circumstances such as financial conditions, tax rates, age and other factors. Therefore, the impact of loss of flexibility arising from any tax-saving proposition must be carefully assessed.

5. Keep in mind, the full implications of today's tax-saving strategies.

   The authors suggest that the expected tax benefits alone cannot be the deciding factor, but that the long-term implications, such as the burden of estate and gift taxes must also be borne in mind.

4.10 Estate Planning

As seen earlier in Chapter 2, this activity is concerned with the transfer of a person's property to his succeeding generation. Some simple precautions were suggested earlier such as ensuring joint ownership of property and availing of nomination facilities, so that there is no hindrance in the smooth transmission of property. However, estate planning involves much more ! Some key concerns are :

1. Identifying the heirs and beneficiaries and deciding on the share of each in different properties.
2. Making adequate provision of financial income for one's dependents.
3. Ensuring that estate transfer costs are kept to the minimum.
4. Providing sufficient liquid assets to enable the estate to meet its obligations.
5. Decision on whether property must pass "inter vivos" or upon death.

The above responsibilities and other nuances of estate planning were touched upon earlier in Chapter 2. The purpose of reiterating these points is to highlight the magnitude and importance of the task. For example, when one dies intestate without having ensured joint ownership of property nor having nominated benefiaries, the survivors will experience a harrowing time trying to establish their claim over the property be it a bank account, a share certificate or real estate. In such circumstances, the tax implications too can be oppressive.[49] Therefore, it is imperative to be proactive in this matter. The desirable measures are:[50]

1. To consciously plan for the financial support of dependents and for smooth transmission of property at minimum transfer costs.

2. Safekeep all relevant documents and information on personal and property matters. These would pertain to, among other things :

   a. Property

      – Share certificates, deposit receipts and other securities such as debentures, mutual fund units and gilts.

      – Passbooks for savings and PPF accounts.

      – Housing allotment letter, share certificate (for co-operative society) and loan documents. In case of land, revenue records.

      – Registration Certificates for all vehicles.

   b. Insurance

      – Policy papers on all types of insurance and ULIP/Dhanraksha certificates.

   c. Tax returns

      – Returns with assessment orders for income, gift and wealth taxes for at least five years.

      As illustrated above, documents relating to business (e.g., partnership deed), family (birth certificates, marriage papers, etc.), employee benefits (provident fund account statement) and estate planning (will and power of attorney) ought to be preserved properly. It must be ensured that family members are familiar with the documents and that they have a clear idea about the value or amount of property and savings.

d. The will should be prepared well in time in a comprehensive and clear manner so that there are no hurdles nor disputes in the process of transmission of one's property.

3. Seek the help of a counsellor – – a tax lawyer or Chartered Accountant to put things in order.

Every year, a couple of days should be devoted to a review of the status of estate planning so that suitable modifications can be effected. For example, if a diary is being maintained on all assets and liabilities, it can be updated for changes that may have taken place. Also, even the will can be re-written if desired. Apart from formal planning as outlined above, spouses, especially wives, must on an on-going basis, consciously strive to become familiar with their husband's business, financial dealings, share in partnership and other transactions of import. There is a peculiar emotional obstacle that prevents many women from getting involved and acquainted from important financial matters relating to their husband's portfolio, business, etc. The very mention of contingency planning causes dismay for it pertains to a period when the husband would not be alive – – a thought that sentimental women would find repulsive. In the process, when the unfortunate event does occur, many women are ill-equipped to deal with the financial matters. The point that needs to be driven home is that getting involved in contingency planning and estate planning is imperative and is not going to hasten the husband's demise !

4.11 It Pays to be Savvy

Performance in personal financial planning can be enhanced by being well-informed and streetsmart. Besides making use of well-knit plans and techniques as discussed in the preceeding pages, individuals could be alert to ways of boosting the effectiveness of these plans. By way of illustrations, a few devices are discussed below.

1. In a PPF account, when withdrawals become due, this money could be used for household expenses, so that a larger sum from income can be chanelled as fresh PPF deposits. This technique would be consistent with the rule that deposits to a PPF account should be made "out of income chargeable to tax," in order to receive the benefit of rebate. Shanbag[51] has shown with the help of an example which contains certain assumptions, that this technique causes the equivalent taxable yields to go as high as 28.85% for someone in the 30% tax slab, and 33.66% for one who is in the 40% tax slab.

2. Gift of money upto the amount exempt from gift tax (Rs.30,000 per year per donor at this writing) ought to be deposited into the PPF accounts of children, to avail of rebate. On maturity, the proceeds being in the nature of capital receipts do not attract tax.[52] The clubbing provision too is avoided since the interest is exempt from tax. Incidentally, such deposits may continue even after the children become majors and rebates will still be available.

3. Insofar as an insurance policy on the life of a child is concerned, the premia paid by the parent should be formally gifted every year. This precaution will ensure that when the policy matures, the amount will be treated as belonging to the child. Incidentally, rebate is available even if the policy is on the lives of adult children, including married daughters.[53]

4. For someone who is unable to pay the premium three years after taking a life insurance policy, a loan may be taken from the insurance company to

pay the premium. The loan will be adjusted against the policy amount after maturity.[54] This reassuring proviso may motivate people to seek a higher level of insurance protection (so long as it's not excessive) and obtain larger tax benefits.

5. ULIP or Dhanraksha ought to be sought first for the insurance portfolio on account of their higher yield, over and above life and accident cover. Interestingly, these schemes which yield around 16% per annum (without considering the benefit of Section 80L) can also be viewed as medium-term capital accumulation schemes, since one may withdraw from either scheme after five years from commencement without losing the tax rebate benefit already received. Hence, a young individual who plans to buy a car in say five to six years, may expressly use a ULIP with the idea of withdrawing and receiving the accumulated proceeds in five years to be used as margin for the car loan ! Subsequently, a fresh ULIP enrollment for insurance cover can be had !

Again, towards the end of one's career when insurance needs have naturally declined, one may lean on ULIP, without the fear of locking up funds for more than five years.

END–NOTES

[1] Gitman, Lawrence J., *Personal Finance*, 2nd ed., (Hinsdale : The Dryden Press, 1981), p.26.

[2] ibid.

[3] ibid., p. 33

[4] ibid.

[5] Griffeth, Bill, *10 Steps to Financial Prosperity*, 1st Indian ed., (New Delhi : S. Chand & Co., 1995), p.25.

[6] Shanbag, A. N., *In the Wonderland of Investment*, 15th revised ed., (Bombay : Popular Prakashan, 1996), p. 360.

[7] Kohn, Meir, *Financial Institutions and Markets*, (New Delhi : Tata McGraw-Hill reprint, 1996), p. 11.

[8] Griffeth, op. cit., Appendix C.

[9] Adapted from Griffeth, op. cit., p. 12.

[10] This point is emphasized in *Tax Saver*, Vol. XVI(4), April 1996, p. 5.

[11] Shanbag, op. cit., pp. 139-140.

[12] Gitman, op. cit., p. 64.

[13] Hallman Victor G., and Jerry S. Rosenbloom, *Personal Financial Planning*, 4th ed., (New York : McGraw-Hill, 1987), p. 20.

[14] ibid., pp. 89-93.

[15] ibid., p. 87.

[16] ibid., p. 89.

[17] ibid., pp. 46-47.

[18] Yasaswy, N. J., *Personal Investment and Tax Planning Yearbook*, 5th ed., (New Delhi : Vision Books, 1994), pp. 159-160.

[19] Shanbag, op. cit., p. 379.

[20] Sindhwani, Sanjay, "When death is profitable," *The Economic Times (Investor's Guide)*, November 18-24, 1996.

[21] Sindhwani, Sanjay, "Taking a fighting stance," *The Economic Times (Investor's Guide)*, February 24-March 2, 1997.

[22] Hallman and Rosenbloom, op. cit., p. 29.

[23] Rao, Narayana K. V. S. S. and L. M. Bhole, "Inflation and Equity Returns," *Economic and Political Weekly*, Vol. XXV, No.21, May 16, 1990, pp. M-91 to M-96. This study found that equity shareholders earned a positive real rate of return over the period 1953-87, the average annual real return being 5.66% over the period (based on Wholesale Price Index) and 4.51% based on Consumer Price Index. It makes out a good case for investing in equity shares.

[24] Sharpe, William F., Gordon J. Alexander, and Jeffery V. Bailey, *Investments*, 5th ed., (New Delhi : Prentice-Hall of India, 1995), p. 10.

[25] Olsen, Robert A., "Investment Risk : The Expert's Perspective," *Financial Analysts Journal*, (March-April 1997), pp. 62-66. On the basis of "survey data gathered from influential expert and knowledgeable novice investors, responding in a natural setting," the principal risk attributes were identified. These are the potential for a large loss, the investor's feeling of control and the level of knowledge about an investment.

[26] Sharpe, et. al., op. cit., p. 13.

[27] Gallea, Anthony, "Getting Behind in Your Personal Finances ?," *Financial Executive*, (January-February, 1992), p. 15. He mentions that "upto one-third

of your portfolio can be in common stocks, without greatly increasing the risk of your portfolio and while simultaneously increasing return in relation to bonds."

[28] Bakshi, Sanjay, "Importance of asset allocation," *Chartered Financial Analyst*, Hyderabad, February 1996, p. 40.

[29] Brinson, Gary P., L. Randolph Hood and Gilbert L. Beebower, "Determinants of Portfolio Performance," *Financial Analysts Journal*, (January-February, 1995), pp. 133-38. The implications of their study are that design of a portfolio involves at least four steps: (1) Deciding which asset classes to include and which to exclude; (2) Deciding upon the normal or long-term weights for each of the asset classes included; (3) Strategically altering the investment mix weights away from normal in an attempt to capture excess returns from short-term fluctuations in asset class prices (market timing), and (4) Selecting individual securities within an asset class to achieve superior returns, relative to that asset class (security selection).

[30] Bakshi, op. cit., p. 41.

[31] The statistics appear in *Discount and Finance*, Vol. IX, No.8, dated February 22, 1997 on page 4. The source acknowledged therein is the Division of Industrial Studies, Reserve Bank of India, Mumbai.

[32] Bakshi, op. cit., p. 41.

[33] Sharpe, et al., op. cit., pp. 883-916.

[34] ibid., pp. 892-894.

[35] ibid., p. 894.

[36] Lynch, Peter with John Rothchild, *One Up on Wall Street*, (New York : Penguin, 1990), pp. 229-234.

[37] Cassidy, Donald L., *It's when you sell that counts*, (New Delhi : Vision Books, 1993), p. 30.

[38] ibid, pp. 40-46.

[39] Nagy, Robert A., and Robert W. Obenberger, "Factors influencing Individual Investor Behaviour," *Financial Analysts Journal*, (July-August, 1994), pp. 63-68. This study collected data from a questionnaire sent to a random sample of individual equity investors. Participants were asked to evaluate the importance of 34 variables as potentially influencing equity investment decisions. It is interesting to note that tax consequences was ranked 11th, ahead of Expected Stock Market Performance (12th), Expected Dividends (15th), and Current Economic Indicators (20th).

[40] Cassidy, op. cit., p. 45.

[41] ibid., p. 46.

[42] ibid., p. 55.

[43] ibid., p. 105.

[44] ibid., p. 106.

[45] Gitman, Lawrence J., and Michael D. Joehnk, *Fundamentals of Investing*, 2nd ed., (New York : Harper & Row, 1984), pp. 755-756.

[46] Griffeth, op. cit., p. 110.

[47] Pattabhi Ram, V., "Retirement Corpus : How to build it ?," *Chartered Financial Analyst*, March 1996, pp. 78-79.

[48] Hallman and Rosenbloom, op. cit., p. 274.

[49] Phillips, David T., "Protecting your estate from the IRS," *Financial Executive*, (May-June, 1992), p. 14. He cites an example to emphasize that "the growth of

estate can dramatically affect estate taxes," and that this is not properly realized by people. He mentions that the family of Senator Robert Kerr of Oklahoma, U.S.A., was asked to pay $ 9 million in cash within nine months of his death to settle taxes on his estate of $ 20 million. The irony was that Senator Kerr was a long-time member of the Senate Finance Committee that enacted the tax laws.

[50] These suggestions are drawn from a handout prepared by a Baroda–based investments consultant, N. Gangadharan.

[51] Shanbag, op. cit., pp. 145-146.

[52] Doshi, Kanu, "Never enough of the PPF," *The Economic Times*, April 28, 1997.

[53] Lakhotia, Subhash, "Return of the day of reckoning," *The Economic Times*, February 15, 1997. The article makes a mention of circular no. 574 dated August 22, 1990 of the Central Board of Direct Taxes, to confirm the point.

[54] Deviprasad, Rajalakshmi, "Sense and Insurance," *The Economic Times*, June 17, 1996.