SEVEN 'R's OF INVESTMENT PLANNING

Introduction

It is well said about humans –"The more I get, the more I want!!"

In today's world, whatever amount of money one earns always falls short because the inflation takes its toll. There has been constant and urgent need to cope up with inflation to maintain desired living standard. If one considers and analyses the other aspects, it can be seen that the factors contributing towards inflation can also contribute towards earning. All this sounds paradoxical; but it is true.

Investment is defined as a conscious act on the part of an investor that involves deployment of money in various available avenues with a view to obtain a target rate of return over a specified period of time. The investor makes a comparison of the returns available from each avenue with the element of risk involved and then makes a decision that he perceives to be the best.

In reality, however, the level of awareness on the part of investor is not always perfect. Hence, most of the investment decisions end up being sub-optimal leading to a persistent effort on the part of investor to locate alternate avenues of investment that would provide optimum returns.This dynamic situation is aided by the facts:-

(i) that fresh investment opportunities keep on appearing in the market.

(ii) the factors - that aid in taking initial investment decision - do change over a period of time.

Investment differs from both speculation and gambling. Speculation is merely a 'gut feeling'. It is not backed by conscious analysis of various advantages and disadvantages. Speculation is a decision taken on the spur of the moment and is mostly based on a 'grapevine' or a rumour. The rate of return in speculatory transactions can be exceptionally high (but the risk is even higher – this fact is generally forgotten). Gambling, of course, is a pure game of chance.

The scope of this article is limited to investment planning for individuals. Thus, in depth discussion on 'Portfolio Management' and on 'Cost of Investment' is avoided.

The Seven 'R's

While analysing the investments and returns from investments, I came across seven words starting from 'R' which play a very important part in the process. In fact,

they sum up all aspects of ‘Investment Planning by individuals’. The first four words are applicable for separate analysis of each investment, whereas the rest are applicable for investment planning. They are as follows:-

(a) Risk.

(b) Returns.

(c) Restrictions.

(d) Rate of Taxes and Duties.

(e) Requirements and Reserves.

(f) Ranking and Ratio.

(g) Reassessment.

Parameters for Analysis of Individual investments

Risk. It is obvious that no one wants to lose the hard earned money. We all earn money through application of some skills and it is our hard earned money. Hence, as far as possible, the investments must be risk free. One must analyse the risk element before deciding on any investment. Some common types of risk involved are:

(i) Risks due to Fraud; e.g. investment in ‘fly by night’ companies or investment in fraudulent schemes that promise extraordinarily high returns.

(ii) Risks due to Change in Government Policy; e.g. Changes in RAPO Rates & Reverse RAPO Rates as also CRR by the Reserve Bank of India in year 2006 adversely affected the interest rates on the loans.

(iii) Risk of Theft; e.g. The theft of money from bank accounts due to illegal use of debit / credit cards.

(iv) Market Risks; e.g. The decline in the securities market in August 2007.

Returns. The investment must give maximum possible returns. The returns are earned when the invested money is put to work. If it was possible for any investment scheme to have zero risk and maximum returns, everybody would have invested their money in such a scheme; but obviously that does not happen. The simple equation of investment and return is : Minimum Risk: Minimum Returns & Maximum Risk: Maximum Returns. If one invests the money in a nationalised bank, the money will be mostly risk free and will earn about seven percent interest; alternatively, if one invests in the fast growing shares of little known companies, one may get even three hundred percent returns in a month but the risk of losing the invested amount may be very high. If one wants returns, risk has to be taken. One has to find out ways of minimising the risk without affecting the returns in the same proportion. This is possible with some diligence on the part of investors.

Restrictions. Each investment carries some restrictions with it. Certain restrictions may be imposed while making the investments; e.g. maximum amount that can be invested in case of certain investment schemes or compulsory registration of immovable property etc. Certain restrictions may be present throughout the life of investment; e.g. premiums payable for insurance policies (otherwise the fear of lapse of policy). Most investments carry some terminal restrictions that affect easy liquidity. Cash in bank is probably easiest to take out. Shares have to be sold to get the money. Company deposits and debentures carry fixed tenure or lock in period.

Rates of Taxes and Duties. The taxes and duties payable is one of the important considerations while analysing any investment. VAT, Sales Tax, Service Tax, Securities Transaction Tax, Excise Duty, Customs Duty and Stamp Duty – all tend to increase the cost of investment and reduce the yield or returns. However, we are mainly concerned with the Income Tax. Last year, there was a lot of discussion about EEE, EET, ETT and TTT of various investments. Here, 'E' stands for 'Exempt from Tax' and 'T' stands for 'Taxable'. The first letter denotes taxability while investment is being made, second letter stands for taxability of periodic or intermediate returns and the third letter stands for taxability of terminal benefits. Thus, 'EEE' means all three are exempt from tax (e.g. investments in authorised provident funds) and TTT means all three are taxable (e.g. investments in company deposits.)

Parameters for Investment Planning

Requirements and Reserve. The requirement of investment differs from individual to individual and from time to time. Some may require investing only for tax saving, some may want quick returns. Also, how much money to invest and for what period is also an individual decision. Some people may need money after ten years for the marriages of their children; some people may not be sure as to the time of requirement of funds. One has to ponder over one's requirements and take a appropriate decision. Also, the amount of reserves is a major consideration. Some very aggressive investors may even borrow substantially to invest; some others may invest even less than 50% of available resources. This again is an individual decision.

Ranking and Ratio. After analysing the individual investment avenues as per the four parameters given above and after ascertaining the requirement of funds, it is better to rank all available investment avenues in a tabulated form and then decide upon the investments. Another important decision is the amount of money to be invested in each investment depending on its ranking.

Reassessment. One of the most important factor that everybody forgets is periodic reassessment of the investments. Reassessment is required because individual circumstances and also the environment keeps on changing. To give an example- investments in infrastructure bonds and in pension policies were very popular three years ago because they provided an additional avenue for tax saving. The situation no more exists because all investments that were eligible for deduction / tax rebate earlier are now treated at par. Similar is the case about capital gain tax on share transactions.

Analysis of Certain Common Investments

Ser No	Investment	Risk	Return	Restriction	Income Tax Incentives		
					While Investing	During Investment Period	While Liquidating
1	Gold	L	M	L	T	T	T
2	Immovable Property	M	H+	H	T	T	T
3	Derivatives	H	H+	L	T	T	T -
4	Shares	H	H	L	T	E	T-, E
5	Mutual Funds						
	(A) Debt	L	M	L	T	E	T, E
	(B) Equity	M	H-	L	E, T	E	T-, E
6	Money Market	L	L	L	T	T	T
7	Provident Fund	L	M	H	E	E	E
8	Bank Deposit	L	M	L	E, T	T	T
9	Company Deposit	L	M+	H	T	T	T
10	Debentures	L	M	H	T	T	T
11	Insurance (Life)	L	L	H	E	E	E
12	Insurance (Other)	L	L	H	T	T	T
13	ULIP	L	M-	M	E	T	T
14	Postal Schemes	L	M-	M	E	T	T
15	Government Bonds	L	L	H	E, T	T	T

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Note: H+ = Very High, H = High, H- = Above average, M+ = High average,
M = Average, M- = Low Average, L = Low, T = Taxable, T- = Low Rate of Tax,
E = Exempt from Tax

Certain Tips For Investments

- Never put all eggs in one basket, however attractive the returns may be. Always go for diversity in investments. If you are investing in shares, deal in at least ten

different shares from different industry sectors. If you are investing in mutual funds, invest in five – six different mutual fund houses.

- When You are investing in a residential house, purchase the house in your name only. If you purchase in any other name, you will not get the benefits. Also, even though you may have sufficient capital, always take some bank loan for purchasing house. It will give you duel tax benefits – deduction of interest / loan repayment in the year of repayment while computing income tax as also deduction of interest while computing capital gains.

- Always try and obtain maximum tax benefits. This can be achieved by the following:-

    - Investing up to Rs. One Lakh per year in eligible avenues.
    - Investing in mutual funds where dividend is tax-free.
    - Investing in authorised provident funds where the investment, interest and terminal benefits all are tax-free.
    - Investing in health insurance policies.
    - Sale of securities after holding them for one year.
    - Sale of other assets after holding them for three years.

- Systematic Investment Plans of various mutual funds are effective against market fluctuations.

- One must try to make withdrawals when the securities market is booming and make investments when it is low. A number of investors have benefited by making investments in securities and mutual funds in the month of August 2007 when the securities market in India crashed owing to the news of security risks in home loans in the USA.

- Never let money lie idle in the savings account of a bank. The least one can do is to open fixed deposit accounts from time to time.

- Viewing any Business Channel on TV and reading Economic Times regularly will pay handsome dividends provided one is able to read between the lines. It is not necessary to believe each ‘expert’, the experts may be biased or incorrect. It is better to understand the reasoning behind the comments of the experts analysts before taking their advice.

- A stock broker is merely required to carry out your investment instructions. Never seek any advice from a stock broker.

Conclusion

To conclude, I state that the most important factor in any investment planning is constant periodic reassessment. The concept of investments is NOT static. It is always

dynamic. The requirements, restrictions, opportunities, avenues and availability of funds keep on changing. One has to be alive to the latest situation. Only then one can hope to get adequate returns from investments.

(Approximately 2000 words)

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