Product Maze
Choosing Financial Products

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CENTRE FOR INVESTMENT
EDUCATION & LEARNING

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Lesson
1

1.1 Linkages in Personal Finance

Financial Planning is the exercise of ensuring that a household has adequate income or resources to meet current and future expenses and needs. The income is primarily derived from two sources:

- Income from profession or business or employment undertaken
- Income and earnings from assets or investments such as rent from property, interest from bank deposits, dividends from shares and mutual funds, interest earned on debentures

Income from business or profession will be the primary source of income in the period when the individual is capable of being employed and generate an income. When this period is over the dependence for income from the assets and investments will increase. Assets and investments as a source of income are typically built over a period of time from surplus income after meeting expenses.

Current income is first assigned to meet current expenses. Surplus income available after meeting expenses is called savings and it is used to create assets that will provide future income or meet future expenses. Large ticket size assets, such as real estate, or, purchases that are not amenable to being met out of regular income, such as buying a car, may require surplus income to be accumulated over a period of time. Typically such assets are acquired with a combination of own funds and loans. Loans result in a liability that has to be met out of current and future income.

- Income is used to meet current expenses and create assets to meet future income needs and expenses.
- Expenses have to be controlled to fit into available income and to be able to generate savings.
- Savings are used to create assets that will generate income for the future needs.
- Borrowings or loans may be combined with savings to acquire assets of a large value or meet expenses.
- Borrowings impose a liability to be met out of income to pay the cost and repay the loan.

Financial planning helps in understanding the relationship between the four elements of the personal finance situation of an individual: income, expenses, assets and liabilities so that all the current and future needs are met in the best way possible.

Financial goal is the term used to describe the future needs of an individual that require funding. It specifies the sum of money required to meet the need and when it is required. Identifying financial goals help put in place a spending and saving plan so that current and future demands on income are met efficiently.

1.2 Suitability in Personal Investments

The funds required for financial goals are accumulated out of savings made from current income. Money saved has the ability to generate income and appreciate in value over time. This feature of money implies that time required to accumulate the funds required will be lower or the savings earmarked for a goal can be lower.

Arvind requires Rs. 20,00,000 to pay the down payment on a house. He is able to save Rs.10,000 each month.

a. If he sets aside his savings of Rs.10,000 in a box, he would need 16 years and 8 months to accumulate the funds.

b. If he puts the Rs.10,000 each month in deposit that earns 10% per annum, he will be able to accumulate the funds in 9 years and 10 months.

Arvind wants to accumulate Rs.20,00,000 in the next five years to make the down payment on a house.

a. If he kept his monthly savings in a box, he would need to save Rs.33,333 each month to reach the sum required.

d. If he puts the savings each month in a deposit that earns 10% per annum. He will be able to accumulate the required sum in five years by saving Rs.25,000 each month.

Using the money saved to generate a higher value over time is called investing. Investing is the activity of employing money in buying assets so that it generates income and appreciation in value over time.
Money can be invested in different assets such as equity, debt, gold, real estate and cash. Each of these investments will have different features on the nature of the return generated, the risks to the return and the liquidity that the investment provides.

Return from an investment may have the following features:
- It may be in the form of regular return, appreciation or both;
- It may guaranteed or un-guaranteed
- It may be known in advance and fixed or it may be uncertain

An investment may be seen as risky if :
- There is a possibility that the capital invested may be lost or depreciate in value
- The returns expected may not materialize
- The returns generated may be inadequate for the goals.

An investment may be seen as illiquid if:
- It cannot be redeemed or sold easily when funds are required
- The value that can be realized on sale or redemption is lower than its correct or fair value
- It can be liquidated only as a whole, irrespective of the need for funds
- The costs related to liquidating the asset may be high

An investment that has a higher risk needs to provide a higher return if investors must find it worthwhile to invest in it. The return from equity shares will be in the form of dividend and capital appreciation. There is however no assurance on the returns that can be high over long investment holding periods. Bank deposits generate only interest income. The income is guaranteed. Since the risk is lower, the returns are also lower. Gold does not generate regular income. It only appreciates in value over time. Debentures generate interest income and some appreciation in value. There is a high degree of certainty associated with the interest income expected. Real estate generates rental income as well as appreciation in value over time. In the initial years, the rental income earned will be a low percentage of the value of the property.