Business Standard

Protection or aggression?

Both have a role to play in ensuring that you have enough to fund financial goals

Kiran Telang May 03, 2014 Last Updated at 21:13 IST

High inflation has reduced the Indian household's ability to save aggressively. Our household savings rate has fallen from 22.8 per cent of the gross domestic product (GDP) in 2011-12 to 21.9 per cent in 2012-13. But it is not just about the quantity, but also the quality of saving. Most households have preferred to play it safe due to the uncertainty in the stock markets.

The popularity of fixed returns' instruments is due to other reasons as well. Familiarity, ease of understanding and easy availability are some of them. Another reason could be lack of awareness about other investment avenues or the difficulty in understanding how these work.

From a risk perspective, it fits in with the theory that most people are loss averse. Given a choice between a sure win of Rs 50,000 and a 50 per cent chance of winning Rs 2 lakh, most people would instinctively choose the sure win. This means they will be happier gaining a small fixed amount, than take a chance of loss even when the reward is much bigger. While capital protection and fixed returns might be very attractive, having all or majority of one's portfolio in such instruments can be detrimental for one's financial health.

Risk from inflation

Inflation can be the biggest risk in portfolios that are heavily skewed towards fixed income instruments. More often than not, these instruments lose out in the long run because they are not able to provide income to keep up with inflation. Even for conservative investors there is a case for investing a small portion of their investible surplus or corpus into inflation beating asset classes like equity.

For those who have larger corpus, fixed deposit and the like might suffice for a lifetime of income, but in such cases, it might affect the quantum of wealth that will be transferred to the next generation. The value of the capital will deplete due to inflation if there is no growth happening there.

There are several products and strategies that can be put in place to ensure capital protection while keeping up with inflation. Some examples are the use of simple products like hybrid mutual funds which allow 20-50 per cent investment into equity and the rest in debt. Allocating a small portion of your corpus/investible surplus into equity, while the major portion is retained in fixed deposits and bonds, can be a strategy. A similar strategy is used in some capital protection oriented products that are available in the market from time to time. Investing the income/interest of fixed deposits or bonds into equity can also help.

Don't overdo tax-saving

For most of us, tax savings means investing in instruments which offer tax benefits under sections of the Income Tax Act, like Sec 80C, Sec 80D etc. For employees with white collar jobs, most of these requirements are usually covered through automatic deductions like Provident Fund contributions. So,

additional investments towards tax savings might not be required.

But the fact is that many investors buy multiple insurance policies in order to save tax. This might result in adequate tax saving, but leave one woefully under-insured. The regulator has tried to address this issue by bringing in rules that make it mandatory for insurance policies to offer a higher amount of insurance cover in proportion to the premium paid, as compared to what was being offered earlier. Still one should do a need analysis for insurance requirement and not look at it as merely a tax-saving tool.

Same goes for health insurance policies that offer tax benefits under Sec 80 D. If the tax benefit offered is maximum Rs 15,000 per annum, that does not mean that one should not take insurance policies costing more than that. Maybe your needs require you to pay a higher premium to ensure adequate coverage.

Tax-saving plus investment
Many of the tax-saving instruments that offer tax benefits are good by themselves as investment vehicles. So even if one had completed the tax savings through other means, these should be a part of the investment portfolio. One case in point is investment in Public Provident Fund (PPF). Erratic investments in PPF as per tax saving requirements will help only save tax, but if the maximum allowed amount is invested, it becomes a fantastic corpus in itself.

There are three factors that go into making this instrument a must have in any individual portfolio. One, it offers tax saving benefit under Sec 80 C. Second, it is tax free at maturity and third, it offers interest that compound is annually. As Einstein said, compounding is the eighth wonder of the world. This helps grow the maturity value of PPF to a good amount. Another example is Equity Linked Savings Scheme (ELSS) which can give an exposure of equity to the portfolio and save tax too.

Instead of trying to choose between capital protection and tax savings, build a portfolio which aims to meet financial goals and aids wealth creation. For this, be aware of your needs, then look for instruments that best suit those needs and are tax efficient at the same time. Third, match this with your risk profile. There might be situations where you may have to accept a higher or lower risk in investments to address these needs.

The author is director, Dhanayush Capital Advisors