EQUITY FUNDS FOR LONG TERM INVESTMENT

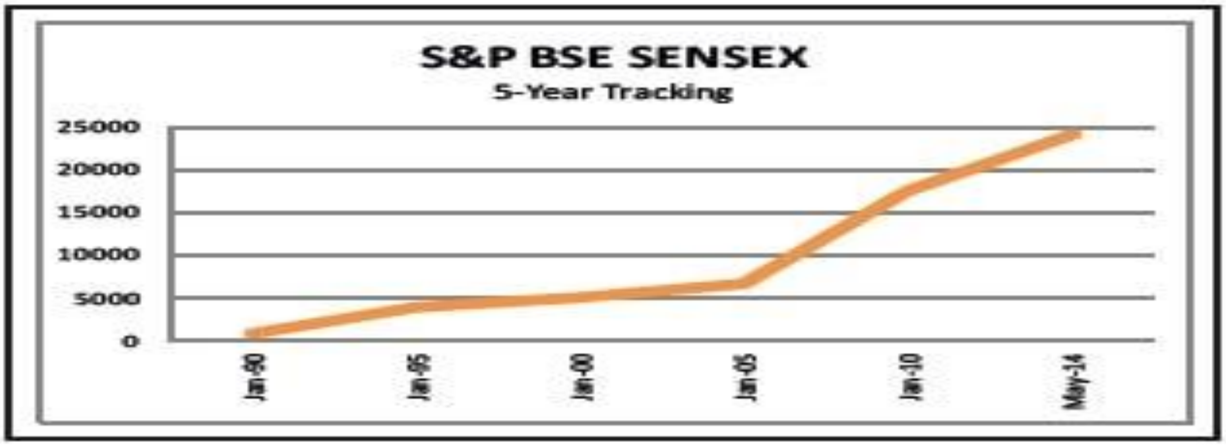
Chapter 15

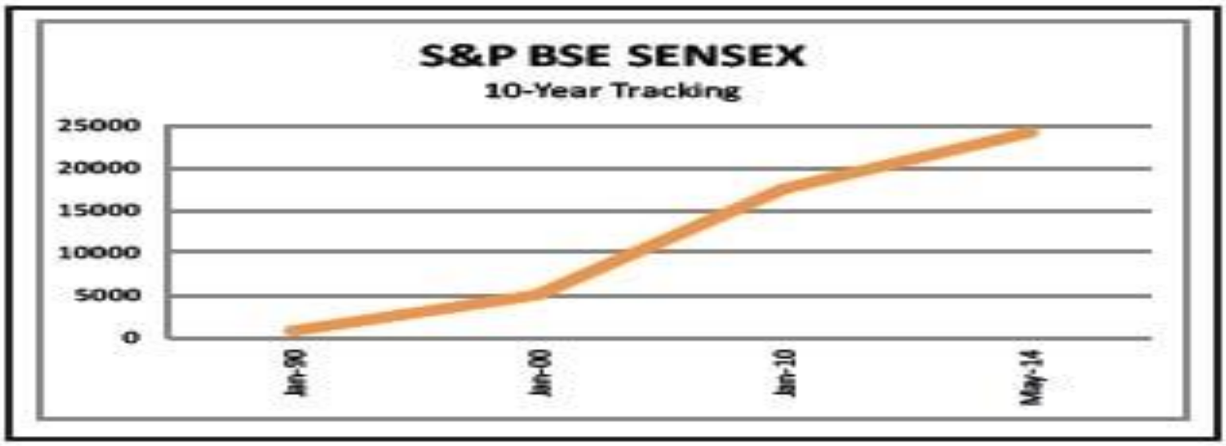
In the long run equity is an asset class that manages to beat inflation and earn positive returns

The biggest challenge facing any form of investment is to beat inflation (or rising prices) in the long run as value of money will depreciate over time. Just like Rs.1000 had great value in the 1990s but not now, the same may happen to Rs.1 lakh in 2030. Inflation thus has a cascading impact on our finances especially if our savings are generating returns lower than the inflation rate. This is also referred as negative real rate of returns where the latter is the difference between returns and inflation rate.

Equity is one of the key asset classes that has the possibility to beat inflation to earn positive real returns in the long run. However, most investors associate equity with the risk of losing money and hence stay away. Some do not invest after having burnt their fingers by investing when the markets were at their peak and made a loss when the markets crashed.

However, one must look at equities from a different angle. Here is an example to make a better connect. When we look at the moon from earth, it looks very beautiful. There are many songs written on the beauty of the moon as well. However, when we see the moon from a telescope or see the photographs of the moon from close quarters, we observe that it has many craters as well which are not visible from a far distance. Taking this analogy for equities, they are only attractive if they are held for the long term but may prove to be harmful if held for the short term. Thus, if you track the stock market daily or monthly or even yearly, you may see many ups and downs but if you track it once in 5-10 years, the fluctuation in returns or volatility would reduce significantly. Thus equity rewards far sightedness than near sightedness.





The three charts explain this more clearly. One is that of the daily movement of the S&P BSE Sensex from 1990 till 2014. The next two are the same time period, but marked only once in 5 and 10 years. The fluctuations in the first graph may scare most investors though the final trend is upwards. See the drastic change when the investment period increases to 5 years and then to 10 years - the volatility drops significantly. Thus over longer periods of time such as 5-10 years or even more, the movement of the S&P BSE Sensex evens out, thereby reducing volatility. The moral of the story is that investing in stocks can lead to losses if you are a short-term trader. Over sufficiently long periods of time, you are more likely to gain than bear losses without the worries of daily fluctuations. But how do you invest in equity? There is no need to get into stocks all by yourself — equity mutual funds can do this for you.

SUMMARY

Inflation is the biggest challenge for returns generated from any form of investment. It is important for real returns (returns minus inflation) to be positive than nil or negative. Equity has one of the best potential to beat inflation in the long run. Investors move away from equity because of the risk of capital loss. However, it is important to be far-sighted than near sighted by tracking the stock market over a 5-10 year horizon than on a daily basis. Volatility of equity returns is significantly reduced over the long run.

NEXT TO COME: BENEFITS OF INVESTING IN EQUITY MUTUAL FUNDS