

A BEGINNER'S GUIDE TO MUTUAL FUNDS



All investments are not equally important. Basic investment needs must be fulfilled before others

If we put our saved money where it will grow, then that's investing. However, there are a number of possibilities available when we want to invest, and it is not possible to make choices without having a way to classify things.

Let us not jump into classifying investments right away. Before we do that, we need to classify our need for making an investment. Investments can be made for a huge variety of needs. You could be saving for emergency medical funds which are usually required at a moment's notice. Or you could be saving for your retirement which is a few decades away, or anything in between.

We have created a useful framework for thinking about these investment needs by dividing them into four levels. Each level is more fundamental than the ones that come after it. You should satisfy the need at each level before going on to the next one.



Those who know a bit about psychology may recognise this system as being based on the 'Hierarchy of Needs', a concept proposed by psychologist Abraham Maslow. Maslow's hierarchy dealt with basic human needs like food, shelter, etc. In the same way, human beings deal with their higher needs after simpler ones are satisfied. Here is the Hierarchy of Investing Needs:

LEVEL 1 - Basic contingency funds: This is the money that you may need to handle a personal emergency. It should be available instantly, partly as physical cash and partly as funds that can be immediately withdrawn from a bank. Online banking and ATMs make it relatively simple to get this organised.

LEVEL 2 - Term Insurance: Calculate a realistic amount which allows your dependents to finance at least short- and medium-term life goals if you were to be struck with a debilitating injury or disease or even face untimely death. You should have an adequate term insurance before you think of any savings.

LEVEL 3 - Savings for foreseeable short-term goals: This is the money needed for expenses that you plan to make within the next two to three years. Almost all of this should be in minimal risk avenues.

LEVEL 4 - Savings for long-term foreseeable goals: Same as level 3, except the planned expenses are more than three to five years away. This level could be invested in equity and equity-backed investments like equity mutual funds.

One could think of many levels beyond this and really, the details matter much less than the concept. Depending on one's circumstances, any of the levels may have to be modified. For example, you may have enough income-producing assets to make insurance relatively less important.

However, this does not decide how much to invest towards each need. This system aims at preventing you from going to a higher level unless the lower one is fulfilled. If you have not put emergency cash in a savings account, then do not buy term insurance. If you do not have term insurance, then do not start putting away money for your daughter's college education, and so on.

SUMMARY

There are a huge variety of investments available which anyone can use. To choose the correct type of investment, we need to understand the different types of needs that an investment fulfils. We have divided investment needs into different levels, which helps you classify them. These levels go from basic needs, such as emergency cash, all the way up to long-term investments.

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