GETTING STARTED - ATTACK OF THE INFLATION MONSTER

Chapter 3

A BEGINNER'S GUIDE TO MUTUAL FUNDS

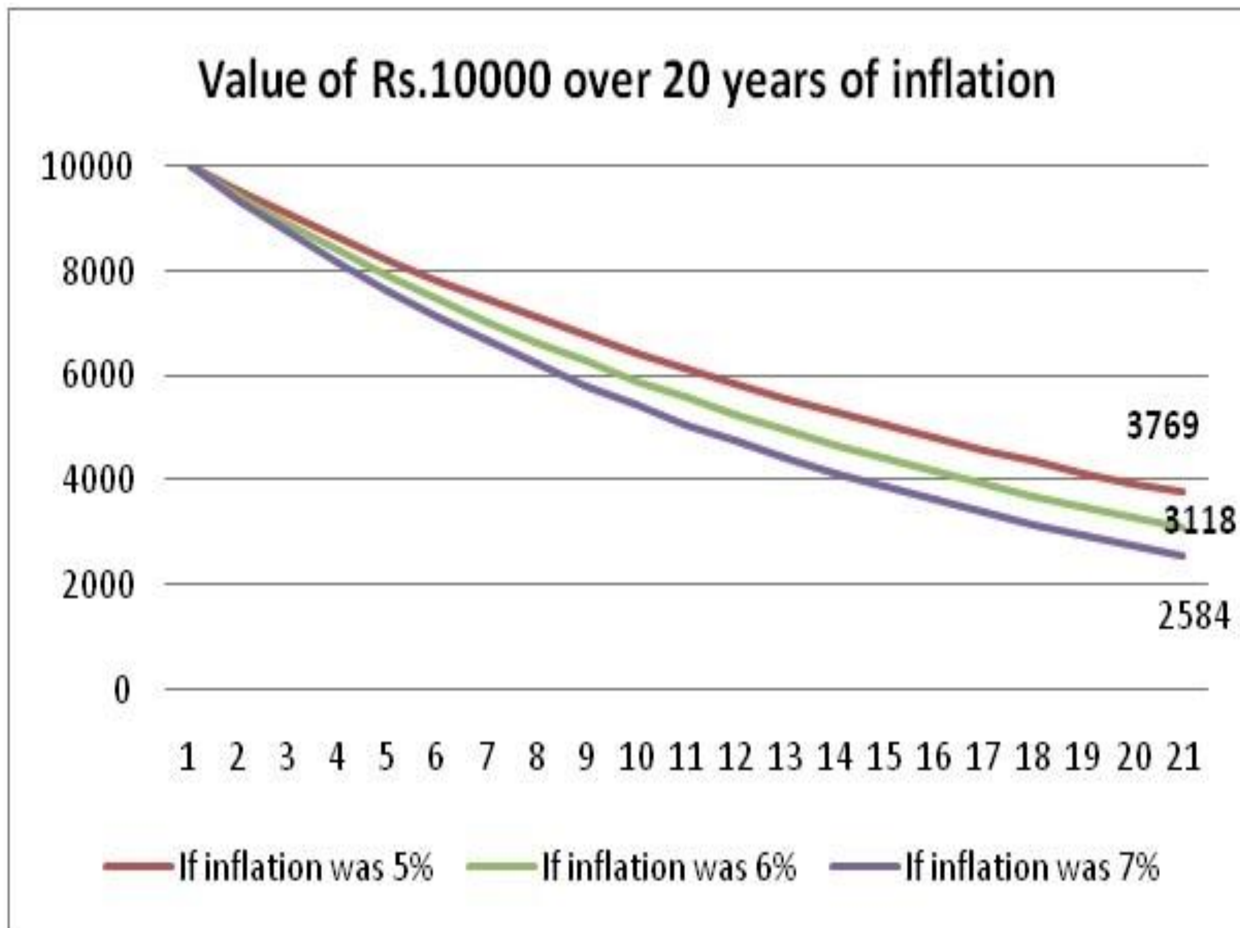
Inflation has been high in India and it is important to provision for the same

It is aptly said, what compound interest gives, inflation takes away. Put it another way - inflation is effectively the reverse of compound interest - it's like decompound interest.

Since each year's inflation occurs on top of the previous year's inflation, it means that the effect is just like that of compound interest. Consider a situation where you invest Rs.1 lakh of your money in a deposit which earns you 8 per cent a year. At the same time, the prices are also generally rising at the rate of 8 per cent a year. In such a situation, your compounding returns will just about keep pace with the inflation.

The actual amount will increase, but what you can do with it won't increase in line. So, for example, over ten years your Rs.1 lakh will become Rs.2.16 lakh. However, at the same time, on an average the things you could have bought for Rs.1 lakh will also cost Rs.2.16 lakh. In effect, the purchasing power of your Rs.1 lakh is not what it used to be ten years ago. The rise in the amount of money you hold is just an illusion and is completely negated by a corresponding rise in prices.

But inflation may not be so kind as to stay at the level of the interest you are earning. What if it's more? And what if this goes on for a very long time. Suppose your returns are 8 per cent but inflation stays at 10 per cent and twenty years go by?



Your investment would grow to Rs.4.66 lakh but things that used to cost Rs.1 lakh would now cost Rs.6.72 lakh. Now, the purchasing power of your Rs.1 lakh is just about Rs.15,000. Your investment has actually made you poorer though many may not have realized the same! In our country, over the past thirty to forty years, the inflation rate has been either the same or a little bit higher than many of the deposits that are available. Unfortunately, far too many people think of the two problems as unrelated.

The common problem is the inability to account for inflation. People think in nominal terms and the future impact of inflation is awfully hard to internalise. The real solution to this is that we should become a low-inflation economy but since that's clearly not on the agenda, savers should mentally always adjust for inflation.

If Rs.1 crore sounds like the kind of money you'll want twenty years from now then you'll actually need to have about Rs.4 crore if inflation rises by 7% every year. If you work backwards from there, you'll need to save about Rs.68,000 a month if the returns are 8 per cent. By the way, if you don't already use it then google 'rule of 72', which makes quick and rough calculations of this sort easier.

That's a depressingly large amount, but there it is, there's no escape from the arithmetic. What that actually tells you is that over long periods of time, you need a form of investment that's inflation adjusted. That equity is risky, is drummed into all investors. However, it takes just a little thinking to figure out that inflation is riskier. And to match inflation, and to get real returns on top of that, you have to latch on to something that goes up with inflation anyway.

This is not difficult because the value of goods, services and assets in the economy is inherently inflation-linked, that is adjusted to inflation. And so risky or not, equity and equity-linked investments are options that may protect you from inflation.

SUMMARY

Rising prices, also called inflation, neutralise the money that you earn from your investments. To judge how much money you are really making, you need to take inflation into account. For example, if inflation is 8 per cent and your money is in a deposit that earns 9 per cent, then you are earning only 1 per cent. Since inflation compounds, (like compound interest) its long-term effect is very large. For example, if your money had doubled in the last ten years, it has actually not grown at all in terms of what you can buy with it.

NEXT TO COME: WHAT TYPES OF INVESTMENTS CAN YOU CONSIDER FOR YOUR PORTFOLIO?