GETTING STARTED - BRINGING BALANCE TO YOUR INVESTMENTS

Chapter 5

A BEGINNER'S GUIDE TO MUTUAL FUNDS

Balancing your savings between different investments is the key

Few of the ways that an investment can make money -are by lending to someone who pays interest; by buying shares and thus becoming part owner of a business; or buy something like gold or real estate, which can be expected to rise in value.

EQUITY INVESTING

When you buy shares in a business, your profits and losses can be large depending on how the business does. Buying shares makes you part owner of a business. Of course, the share is too small for you to have any say in how the business is run, but the financial rewards are the same as any other owner.

When the business pays out part of its profits as dividend, then as part owner you get your share. When the business becomes more valuable, the price of its shares increase and your wealth too increases. Like any business owner, you can decide to sell off all or some of your shares or keep them for future gains. Conversely, if the value of the shares goes down, you could lose money. If the business starts doing very badly, you could lose a large chunk of your investment.

DEBT INVESTING

A very different form of making gains is to lend money to someone. Note that unlike shares, we didn't say 'lend money to a business'. Instead we said 'lend money to someone'. That's because you could be lending not just to a business, but even to a government or some other entity. When we say lending, it includes activities that you may not normally think of as a loan.

Lending just means giving someone money and getting interest income in return. For example, when you make a deposit in a bank (it could be a fixed deposit or a savings account), you are lending money to the bank. However, the scope of gains is sharply limited compared to investing in shares. When you lend, your gains are limited to the

interest rate that the business has agreed to pay you. No matter how successful that business may become, you are not going to get more than that. Of course, the risks are limited too. In most kinds of deposits, the risk of not getting your interest is rather limited. So the rewards are predictable and so are the risks.

In the third kind of investment, the risks and rewards are the easiest to understand. You buy something, if the price goes up that's great and if it goes down then you lose money.

In terms of actually choosing an investment from the three, the complexity is of a different scale. Equity is more complex than the others. There are literally hundreds of companies whose shares you could buy from the stock market and it's not easy to make the right choices. Fortunately, there are ways of making the right choice easily.

ASSET REBALANCING

Asset rebalancing is the most useful and yet the most ignored idea in the world of investing. However, it's actually quite easy to implement, especially for mutual fund investors. It is worthwhile to carefully understand the concept and see whether it can be worked into your portfolio. Asset rebalancing means investing with a target in mind, in terms of how much of your investments should be in debt and how much in equity. Since the two won't rise in tandem, the 'rebalancing' part involves periodically shifting money from one to the other in order to stay on the target. However, that's a simplistic view. It's far better to do this on a rule-based principle. That way, you are not forced to make a subjective judgement of when is the right time to decide that a certain percentage of your investments should be in fixed income and the rest in equity.

For younger investors, the fixed income proportion could be as low as ten per cent, but it shouldn't be zero. For those with a more conservative approach, it could be higher. Retirees could have another approach. But these are just guidelines.

Asset rebalancing means that instead of seeing the equity-vs-fixed income question as a black-vs white binary choice, you should be seeing it as a shade of grey. Once every year or so, you could 'rebalance' your portfolio. What this means is, if the actual balance has veered away from your desired one, you should shift money from one to the other in order to attain the original balance.

When equity is growing faster than fixed income—which is what you would expect most of the time—you would periodically sell some equity investments and invest the money gained from the sale in fixed income so that the balance would be restored. When equity starts lagging, you periodically sell some of your fixed income investments and move that money into equity.

Some readers would have seen the fly in the ointment, or rather, two flies. One is the amount of monitoring or work required; and two, the tax implications from periodic sales and investments. Both are easily taken care of by using a balanced fund. These funds are the most underappreciated idea in mutual fund investing. Balanced funds do all this automatically in a tax efficient manner. More importantly, when the equity market goes down, balanced funds are expected to fall too, but the fall is relatively less. While balanced funds typically invest more than 65 per cent of their assets in equity to qualify as equity mutual funds for tax reasons, less aggressive rebalancing options are also available. The Monthly Income Plans or MIPs typically keep equity at less than 20 per cent or so and can be a good option for more conservative investors looking for low equity exposure.

SUMMARY

For most investors, a particular combination of fixed-income and equity investments is suitable. This is asset allocation. Shifting money between the two as one or the other gains more, is called asset rebalancing. Asset rebalancing reduces risk and helps you cope with volatility

NEXT TO COME: GETTING STARTED - WHY YOU NEED AN INVESTMENT OBJECTIVE