GETTING STARTED - WHY YOU NEED AN INVESTMENT OBJECTIVE

Chapter 6

A BEGINNER'S GUIDE TO MUTUAL FUNDS

Specifying exact goals that investments must achieve is a crucial step in eventually meeting those goals

Understanding and deciding on investment objectives is a crucial stage which many people are unable to do. The importance of doing this well- and the pitfalls of doing it badly- are demonstrated by the following example, which an analyst came across while studying real-world investment portfolios.

The investors were a retired couple who, despite having a good understanding of investing, were unable to figure out whether they were on the right track for their goals. They had investments in a number of funds, mostly equity. They also had a number of needs for which these investments were made. One, they needed a monthly amount regularly to meet household expenses. Two, they needed emergency funds that could be withdrawn at short notice for unforeseen uses. Three, they had some large family-related expenses coming up in about three years. And four, there was the money they would need in the long run to fund their monthly living expenses far into the future as prices rose and needs changed.

Even though this couple had chosen their funds well, they were having problems understanding whether they were on the right track. What they needed was nothing out of the ordinary. In fact, many others have more complex needs. Even so, it was difficult for them to be confident that their investment portfolio was indeed the right one for the job.

But that wasn't their fault. Understanding how an investment portfolio maps onto a set of different needs is practically impossible. Some of the needs are contradictory. For example, the short-term income needs require stability while for the long-term nest egg, high returns are more important. Looking at a list of ten or more funds; with SIPs, dividends and withdrawals of varying amounts flowing in and out; with different performance and quality levels; and different expectations of risk and returns, it is impossible to figure out, even roughly, whether the portfolio will do the job.

So what's the solution? Some sophisticated analytical tool that will give us an insight? No, actually, it's something that someone in your family probably already practices, or at least used to in the decades gone by. The solution is bags- separate bags for each need.

Do you have a grandma in your family who used to save money by keeping it in little bags, each for a different purpose? Lots of us do, or at least did in earlier days. Many of us know of women in the older generation who would run her family's entire life's finances on this basis. They typically have little pouches with a drawstring around its neck, like a pyjama. When the husband brings home his monthly salary, they put some money in the vegetables pouch, some in the milk pouch, some in the household servant's pouch and the dhobi pouch and so on. There were also a few bigger pouches that were meant for savings, as for a daughter's wedding. This pouch would be converted into some gold trinket or the other every few months.

While financially sophisticated readers will call this system primitive and sub-optimal, it has a lot going for it. It was a simple system, easy to implement and easy to understand and above all, it worked. Most importantly, it incorporated one of the golden rules of personal investment management- separate portfolios for separate goals. The old lady would not have been such an organised household manager if she had kept all the money into one big bag, and nor should you.

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: POWER OF COMPOUNDING IN MUTUAL FUNDS