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Financial Freedom: A Need and not a Dream

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Financial Freedom: A Need and not a Dream

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1. Abstract

Being aware of Personal Finance Management is one thing, and actively practicing the same is a totally different thing.

In today's changing priorities, balancing expectations of next generation and previous generation, the current generation is facing acute financial pressure to accommodate requirements and aspirations of their family.

Changing world economies, dropping interest rates, racing inflation, upgrading lifestyles and false ideas of success are driving currently earning generations crazy.

In such a scenario, understanding and managing the finances, planning for the top priorities and retiring without worrying about the future, seems like a distant dream.

With bombarding ads of financial products and doorstep executives, finding neutral Investment Advice is also a rare instance.

However, after the retirement age, one has to live as long as 25 - 30 years without any monetary income. Hence, executing a plan for Financial Freedom - the term used to notify - not working for money - is no longer a dream, but a need of the hour.

2. Introduction

Finance and Mathematics are the subjects that very few are fond of! Even if one is good in either, seldom they like the other. When it comes to personal finance, people seem to maintain distance from the subject and spend a minimum amount of time, only for legal responsibilities and taxation purposes.

Money matters are not taught in any formal education system. Also discussing about Income and Investments with a third person is often a taboo subject. Generations after generations are carrying the same impression and passing the same message to next generations on not to disclose the financial information to anyone.

Not having the expertise and not seeking advice either, makes it very difficult to manage personal finances and more often than not, we see people struggling for money. Not that they are not earning a good amount, but they are not trained for how to spend, save and invest. This makes it impossible for them to make the right decisions, at the right time about their money.

In this paper, we will be discussing about the principles of financial planning, stages in a common man's financial life and how to earn Financial Freedom to have secured old age life.

3. Indian Investors

When we compare globally, for generations, Indians are conservative in their spending and saving patterns. With the influence of western world, we are fast changing into a consumer economy. Also, traditionally, the saved amount is mostly invested in Gold or Fixed deposits.

According to a business-standard.com article about 2015 SEBI investor survey (ref: https://www.business-standard.com/article/pf/indians-prefer-fixed-deposits-to-equities-mfs-for-investment-sebi-survey-117040500977_1.html), it revealed that 95% Indians prefer Bank Fixed Deposits to park their savings, while less than 10 per cent opt for investing in mutual funds or stocks.

Although, this survey is little dated, reality has not much changed. One of the reasons could be – Perceived Safety is the No. 1 priority among Indian Investors. Many do not bother about the returns on income (ROI) against safety. That is the reason, investment insurance products are still popular despite the fact, they are on the lowest side of ROI spectrum.

4. Life stages of an Investor

"Investors are not born, they are created"

Being an Investor is a mindset and not a profession. It is a specially nurtured habit of abstaining from instant gratification and planning for the future. It is to look at the short term and long-term goals with a perspective and to plan and act over it periodically in a disciplined manner.

Certainly, it is a manifestation of self-discipline, patience and desisting temptation of spending. This journey could be quite long, if the objectives are not clear and a serious thought is not given to it.

5. Early life of a new earner

Spending and Overspending

New generation earners, barring few exceptions, are fond of technology, fashion, travel, lifestyle and want to experience all material things that life has to offer.

Singles or newly married couples mostly spend all of their earnings on “lifestyle spends” far ahead of their needs.

With the Credit cards in hand and personal loans at their doorstep, they are lured into what they don’t realize – spending their future income.

Instant gratification is the key for their life. With limited responsibilities, still feeling secured under parent’s protection, this age group only sees money as a medium to “buy happiness” from external means.

They don’t like to have any boundaries, as they are enjoying their money freedom for the first time in their life. They also don't like to listen to elderly advice at this stage, as they feel righteous about making decisions about their life and how to spend their money.

6. First wakeup call

Entering into Pride of taking loan – Credit Card

Thanks to the credit card industry, who make 24% p.a. loan look so attractive! Sales executives are prompt enough to lure young earners into selling credit cards.

After Initial Rosy life stage, at some point in time, they start realizing that something is not quite correct. Monthly expenses & spends are becoming a drag on their earnings. Their work responsibilities have increased, but their salary is not increasing in proportion to their spending habits.

That iPhone or Expensive Smart LED TV has started to haunt now, taking away significant portion of their income in the form of Credit card or Personal Loan EMIs.

However, many of them don't want to give up anything from the lifestyle that they have chosen and lived in, setting a standard for themselves. It may be because of the false pride, due to peer pressure or to please their partner.

7. Thick clouds of financial crisis

Leading to a cliff of financial crisis

At this point in time, they start getting pinched seriously by financial crunch. As the family grows from 2 to 3, planning for the future of a child is thought of for the first time.

It is then realized that so far there are no savings done and that the current income is becoming insufficient to cater to family needs. By now, if the couple has purchased a home, home loan EMI becomes the single largest load on the income.

With additional child expenses, the female partner, if not working so far, takes a lead to start/restart her career once the child becomes 2-3 years old, to add-on to the family income.

This is the first time they start to have some amount of savings from their income in the bank balances.

Few smart bank executives or some self-declared financial advisors would sell them “Child special” plans to fulfill their emotional needs, but not necessarily their future financial needs. With no financial literacy, they simply make a decision to buy one of the plans presented to them.

Many investments are done to avoid taxes at this stage, that may turn out to be wrong ones in a long run.

A few families continue to face financial crisis and get deeply trapped by paying monthly minimum balance of credit cards, getting newer credit cards with balance transfer offer or opting for personal loans to clear previous debts. This is a big RED flag for the family.

8. Changing habits - Spending to Savings

Shift in the mindset

Having realized that savings are important for rainy days, the family starts to accumulate what is left over from the monthly or annual commitments.

Preferred choice is obviously bank FDs, the easiest and most liquid form of investments.

Wiser families cut down on discretionary spends and increase the savings.

At this point in time, mostly everyone has their insurance policies, FDs and with a lot of advertisement a very small SIP in mutual funds.

9. Meeting Financial Guru

The real enemy: Inflation

If the family is lucky enough and one of the spouses take initiative in attending some financial awareness program, they will come to know the biggest enemy of the investor – Inflation.

Inflation is a silent killer of the purchasing power that money gives with time. With time everything that we buy today gets more and more expensive every passing year.

Chart 1: India’s retail price inflation rate

Chart 1 shows India’s retail price inflation rate for past 7 years. We can see that, it touched 12% towards end of 2013. After 2015, it is ranging between 2% to 6%.

Even if we consider 6% inflation, the impact is so much that ₹1 lac can only buy ₹20,000 worth things after 30 years. (See *chart 2*)

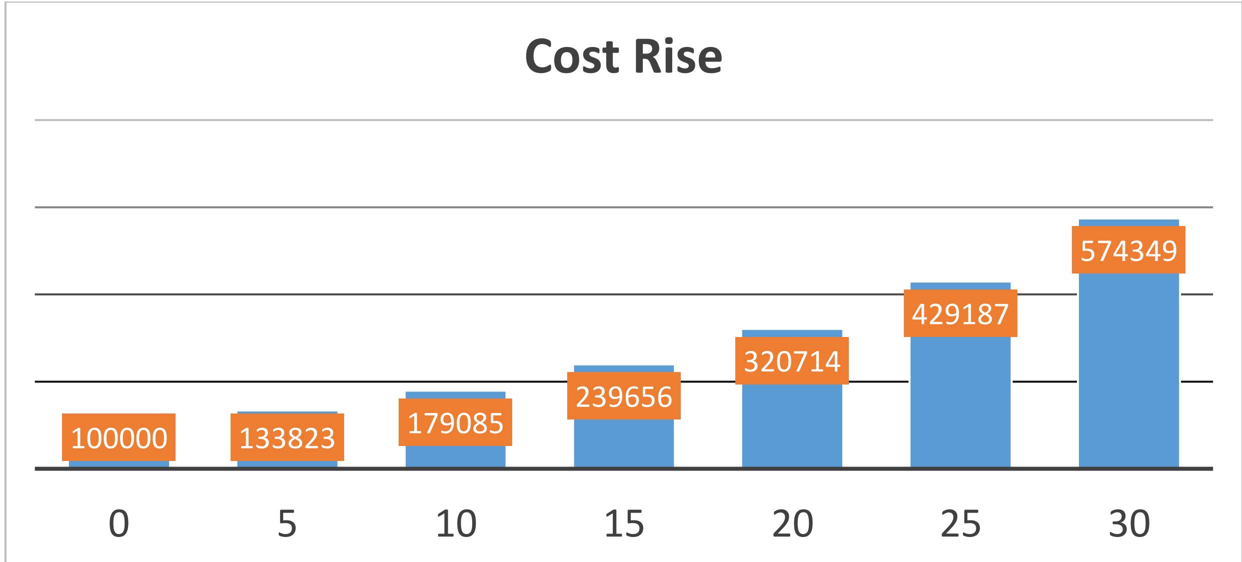

Chart 2: Impact of 6% p.a. inflation on monthly cost of ₹1 Lac

On the other hand, the monthly expenditure of 1Lac Rs will rise to 5.74 Lacs in 30 years. (See *chart 3*)

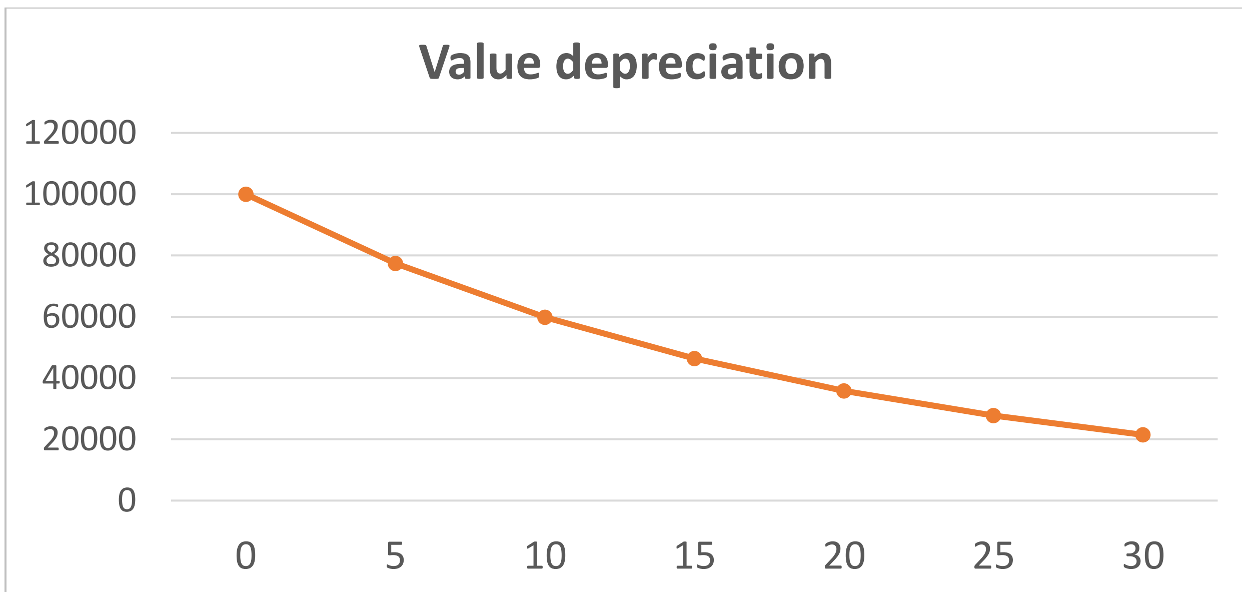

Chart 3: Impact of 6% p.a. inflation on purchasing power of ₹1 Lac

Common investors are satisfied by seeing their capital is incrementally growing. Nobody will obviously like to see it reducing. Therefore, fixed income instruments are their first choice.

What is overlooked is *the rate* at which the capital is growing. issue is that, the impact of Inflation and taxes is not considered and just the rate of interest is taken into account on the face value.

Real rate of return vs Nominal rate of return

Nominal rate of return is the published rate of the fixed deposit, for e.g., let's assume that as n%. Real rate of return is what actually the investor gains on the capital after considering costs such as inflation, taxes and brokerage. For simplicity, we will consider only inflation rate as i% and Real rate of return as r%.

The formula is as below

$$r = \frac{1 + \frac{n}{100}}{1 + \frac{i}{100}} - 1$$

So, assuming an FD is earning 7% interest and the inflation is at 6%, the real rate of return will be r = 1.07/1.06 – 1 = **0.94%** p.a.

FD rate after considering deduction of taxes of 20%

n * (1 – 0.20) = 7 * 0.8 = 5.6%

Putting this into the equation

Real rate of return r = 1.056/1.06 – 1 = **- 0.3% p.a.**

Which means the capital is eroding by 0.3% every year, even after putting the capital in FD earning 7% p.a. returns

Clearly any investment earning post tax returns less than projected inflation rate is eroding the capital. This is contrary to the belief of capital protection.

If we consider compounding this over a period of time, the gap only widens and the capital continuously keeps on losing its purchasing power silently.

10. Wealth creation: Only a dream?

Generation of wealth over long term

With inflation eroding the money year after year, is accumulating and growing money only a distant dream? If an investor finds avenue that provide returns beating the inflation by a positive margin, this could turn into a reality. Gone are the days, when one used to earn Fixed Deposit returns of 12% p.a.

With a well-known saying in the finance world, Low risk, Low returns, Investor has to step out from the comfort zone and make an advancement into High Risk High return territory, preferable to their risk appetite, for long term wealth creation.

11. Business world

Can I have my share of business profit?

A fixed income earner in employment finds it only natural to invest in fixed income instruments. Often, doing a business is not their cup of tea, because of uncertainties and risks involved in it.

One may not be able to do business while in full time employment. But, with the help of securities market, there is an opportunity to become *partner* with successful business and sharing the profits, too.

However, like any business, one cannot guarantee the amount of profit that may be earned. Buying a stock may or may not be profitable depending on several factors. One needs to have specialized skills to understand when a stock is to be purchased and when it is to be sold.

12. Mutual funds

Sharing common objective

A better interface for common investors into securities market would be through Mutual Funds.

Mutual funds, as the name suggests pool money from several like-minded investors whose common objective is to earn and share profits on the investments done. Moreover, each mutual fund scheme has a specific investment objective that defines *how* they are planning to earn the profit over the pooled money.

There are several mutual fund companies across India, called as AMCs or Asset Management Companies. They have one or more designated and qualified fund managers allocated to every mutual fund scheme. they also have a dedicated expert research team empowered with data analysis tools to make the buy/sell decision about the securities.

Each scheme decides where the pool of money will be invested. based on that there are broadly 2 types of mutual funds – Equity and Debt.

Equity Mutual Funds primarily invest in shares of listed companies, while Debt Mutual Funds invest in Fixed Income Assets like government securities, corporate bonds, etc.

Historically it is seen that barring initial years of volatility (Price fluctuations), in the longer run, Equity Mutual Funds have almost always beaten the Fixed Deposit returns by a big margin. This makes them a clear winner beating the inflation - the enemy of investors.

13. Role of Securities Market in Investing

Why investment in Securities markets is unavoidable

We may think that the past performance of the equity or equity related products beating the inflation was by fluke.

But if we think rationally and we will find that securities are nothing but a partnership in a business to the extent of the share. the appreciation of the equity value as well as sharing of profits (dividends) are the 2 things that equity investors enjoy.

If we see the pattern - inflation has been always in the range of returns given by fixed income instruments like FDs. off by either 1-2% and/or 2-3 years in terms of timeframe. Businesses need to earn much more profit than the fixed income instruments, because their loan/debt is nothing but a fixed income instrument. That is why doing or investing in profitable businesses has a potential to beat inflation.

YEAR	SENSEX	YEAR	SENSEX	YEAR	SENSEX	YEAR	SENSEX
1980	148.25	1990	1,048.29	2000	3,972.12	2010	20,509.09
1981	227.72	1991	1,908.85	2001	3,262.33	2011	15,454.92
1982	235.83	1992	2,615.37	2002	3,377.28	2012	19,426.71
1983	252.92	1993	3,346.06	2003	5,838.96	2013	21,170.68
1984	271.87	1994	3,926.90	2004	6,602.69	2014	27,499.42
1985	527.36	1995	3,110.49	2005	9,397.93	2015	26,117.54
1986	524.45	1996	3,085.20	2006	13,786.91	2016	26,626.46
1987	442.17	1997	3,658.98	2007	20,286.99	2017	34,056.83
1988	666.26	1998	3,055.41	2008	9,647.31	2018	36,068.33
1989	778.64	1999	5,005.82	2009	17,464.81	2019	41,130.17

Table 1: BSE Sensex Journey since inception

Historically, BSE Sensex was 100 in 1980 and as on 2019, it is above 40000. (Refer *Table 1*). It has grown 400 times and in terms of CAGR, it has given returns above 16%. During the same time, fixed income instruments have given an average return of 8%.

However, if we see the chart of SENSEX (refer *chart 4*), it is not a straight line. In fact, in 2008, it collapsed downhill from 20000 to 8000. That was the biggest crash ever experienced by the stock market. However, within 2 years, it bounced back. This happens a few times to correct the unnatural growth of prices in stocks. Even if those unfortunates, who invested at 20000, just before the crash, but stayed invested, their money, by now, would have doubled.

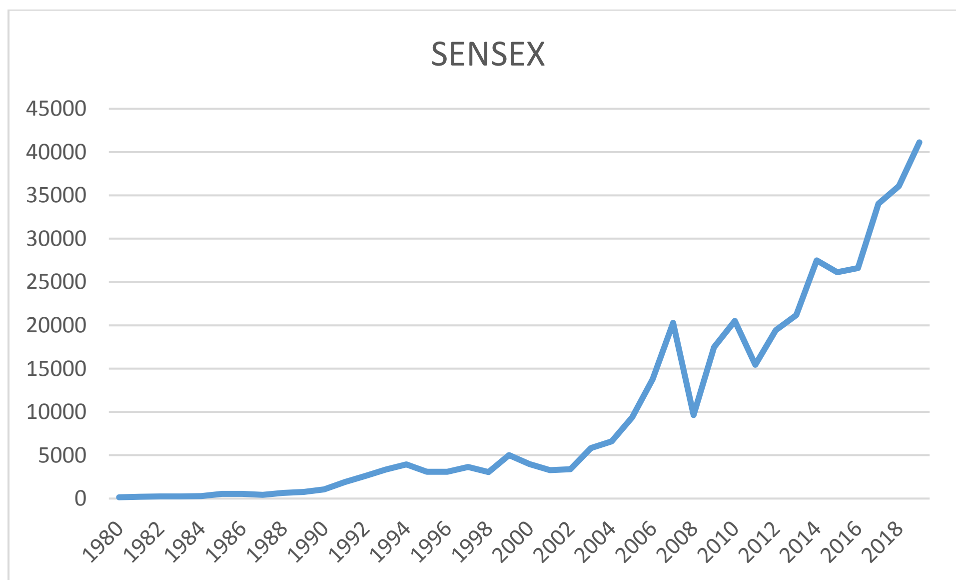

Chart 4: BSE Sensex Journey since inception

So, as a thumb rule, we may assume that over the longer period, equity market will give returns that will beat inflation.

This assumption becomes more realistic, as the timeframe is expanded beyond 10 to 15 years.

14. Risks involved

How a novice will invest in this risky business?

It needs required expertise to invest money in right securities at the right price. However, equity based mutual funds have made the job a bit easier.

People often read the warning "Mutual Funds are subject to market risk" or "Past performance may not be sustained in the future". What they should read and act upon is the next part of the statement - "Read all scheme related documents carefully before investing" and simply avoid investing.

When dealing with direct equity, one should know that there are 2 different profiles work with the market - trader and investor. People often hear horrifying stories of losing money, mostly from the trader profile. Investors in the securities market is a long-term profile and they simply and consistently invest in quality stocks and earn the returns over a longer period of time. It is not that they don't *ever* lose the money in the deal, but they tend to earn *more* money than they lose and the net returns are significantly higher than inflation.

Investing directly in equity requires higher level of skills and knowledge, behavioral aspects like patience and discipline, and also risk-taking appetite.

Mutual funds have reduced the need of skills and knowledge to a great extent, because that is being handled by experienced experts called fund managers. With investment methodology like SIP also helps contain the volatility risk to a certain extent.

But understanding and selecting the right mutual funds, staying investment is bullish and bearish market cycles until the financial goals are completed, etc are basics of discipline that are expected to be shown by the matured investors.

15. How far the investment will last

Saving rate vs Spending rate

When building the retirement corpus, one is aware of their rate at which the money is being saved. However, when they get into the disbursal phase, it is very important to understand and control the "Spending rate" or how fast they are consuming their investments.

If the consumption rate is higher than the rate at which the investment is growing, the corpus will deplete fast and will not last longer during the retirement age.

In addition, even if the same lifestyle is maintained, the expenses will still increase year after year, due to inflation.

So, as a wise investor, one needs to build enough corpus for the retirement and stay invested that continues to grow beating inflation and the consumption rate should be lesser considering the rate of growth and inflation.

Research indicates that a retirement corpus of

300 x monthly expenditure

is needed to reasonably beat the inflation and to make the corpus last for the lifetime keeping the current lifestyle.

While retirement corpus is the biggest financial goal, one must not overlook other critical financial goals such as children's education, marriage. Also planning for recreational goals such as vacation should be considered as well.

16. Conclusion

Every individual must be aware of the impact of inflation on their investments, as well as their expenses. In order to counter inflation - the only enemy of investor – money should be invested in the instruments that will beat inflation. For the same, calculated risks must be taken in the early life to avoid a frugal lifestyle in old age.

Comparing different asset classes like Gold, real estate, Equity mutual funds, FDs, bonds, etc, on the merits of liquidity, consistency in the returns, ability to beat inflation, better faring on taxation, Equity investments stands leaps apart from other conventional investments, in terms of consistency, liquidity and continuity.

Changing the mindset from spending towards saving, investing regularly in asset classes that beat inflation, planning for the family's financial goals and reviewing the investment performance regularly makes the journey of financial freedom a success.

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