Money Management

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Introduction

Money management is an important life skill. Unfortunately, most of us learn it after various hits and trials on our own. However, the good news is that money management can be learnt. And it is not rocket science but simple common sense.

The guiding principles to manage your money would be:

1. Know Yourself
2. Know how your money is doing
3. Make Your Money Work: (And not just you work for Money!)

1. Know Yourself: We have a very vague idea about our money.

Like, have you figured out your risk profile/appetite? Are we conservative or aggressive investors? Do we know about our income and expenses, net worth? Do we know that our portfolio follows the optimum asset allocation principles?

The idea is that, if we had a way to measure income, expenses, portfolio, risk profile, etc., we could have a discussion on how to improve them. No records, no improvements.

We also need to be aware of our money behaviour. Once you are aware, other things follow. In many cases only a very small amount (the 'tip') of information is available about a situation, whereas the 'real' information or bulk of data is either unavailable or hidden. It is similar to the iceberg where only about 1/10th of an iceberg's mass is seen outside while about 9/10th of it is unseen, deep down in water. We need to see beneath our surface personalities in order to make better decisions on important things of life. The key to the best financial decisions lies in the understanding of our own mind, both conscious & subconscious mind.

2. Know how your money is doing: Now that you have numbers ready, the improvements follow naturally. For example, you see that your percentage spend on "eating out" is 2-3 times the monthly grocery bill or it forms 25+% of your expenses. Also, you will get an idea how to balance your portfolio according to your risk profile. You will match the portfolio with your risk appetite and see if you can take more risk or go more conservative. In other words, you get to decide your asset allocation strategy.

3. Make your Money Work: Other than tracking your earnings and your expenses, it is important to see if your money is working for your future. How about allocating your income among fixed expenses, discretionary expenses, short term savings and long term investments? It's like assigning goals for your money.

Pay Yourself First

Pay Yourself First is a foundation principle of money management. Though it's simple to understand, in reality very few people know how to use the principle. The phrase "pay yourself first" means that instead of paying all your bills and expenses first and then saving whatever is left over, do the opposite. Set aside money for investing, retirement, college, a down payment, or whatever requires a long-term effort, and *then* take care of everything else. Because the savings contributions are automatically routed from each pay-check to your investment account, this process is said to be "paying yourself first"; in other words, paying yourself before you begin paying your monthly living expenses and making discretionary purchases.

This simple system is a very effective way of ensuring that individuals continue to make their chosen savings contributions month after month. It removes the temptation to skip a given month's contribution and the risk that funds will be spent before the contribution has been made. Regular, consistent savings contributions go a long way toward building a long-term nest egg, and some financial professionals even go so far as to call "pay yourself first" the golden rule of personal finance.

How to grow your Money Tree:

The best time to plant a tree was 5-10 years ago. The second best time is NOW.

Most young people want to know about investment products where their money would "multiply". Ask them how much they knew about financial products? Often, the answer is Zilch, nothing. But frequently their only interest is in the investment product where their money would multiply. Though we don't have time or interest to learn about building our "Money Tree", we want instant solutions. We just want the big money tree. Even though we know that it takes years for a tree to grow. The only thing that can be done instantly with the tree is to cut it, which can be done quite quickly!

Moreover, this is a dangerous mistake we make. When young people wanted instant solutions without learning more about financial products, they make themselves vulnerable to financial adviser's who sell products that suit their requirements and not their client's. These financial advisers come to know that their client/prospect is an ill informed person & greedy and they make the best use of this information to sell products that maximize their commissions and not their client's!

Money grows like a tree: not on it!

So by looking for instant solutions, we end up hurting ourselves. Instead of building a money tree, we end up cutting the tree. As with a tree, nothing happens instantly. To be successful in any field, we need to constantly increase our knowledge and skills in that field. Also just focusing on the fruits and leaves of a tree is not enough. We have to water the roots and save the growing tree from external attacks.

TIME VALUE OF MONEY & MAGIC OF COMPOUNDING

The Time Value of Money

Let me take a simplistic example to understand the time value of money. Imagine you have Rs. 1,00,000 with you and you have the following options (inflation rate is 5%):

Give it to a friend who will return Rs. 1,00,000 after 1 year.

Put it in a Savings account which gives you 5% annualized return.

Invest in Mutual Fund/Stocks which can give you a return ranging from -50% to +50%

In option 1, The present value of the Rs. 1 lakh that you get after one year is actually (1-5/100)(1,00,000) = Rs. 95,000. Do you realize that you have actually lost money?

In option 2, the money grows by 5% to Rs. 1,05,000 but once you factor the inflation (5%), you are back to the square one. Better to spend the money today rather than wait for one year.

In option 3, your future value can be *higher or lower* than the present value.

The Magic of Compounding

If we could appreciate the "Magic of Compounding" we would understand the benefits of starting early and discipline! Let us understand the power of compounding with the famous story of the Persian emperor who was so enchanted with a new 'chess' game that he wanted to fulfill any wish the inventor of the game had. This inventor, a mathematician, decided to ask for one seed of grain on the first square of the chessboard doubling the amounts on each of the following squares. The emperor, at first happy about such modesty, was soon to discover that the total yield of his entire empire would not be sufficient to fulfill the 'modest' wish.

1 seed of grain compounded to 18440000000000000000 grains on the 64th square!

Option I: Age 25, Invest Rs. 2000 p. m. till age 60; Asset @ 10% growth is Rs. 65 lakhs

Option II: Age 30, Invest Rs. 2000 p. m. till age 60; Asset @ 10% growth is Rs. 39.5 lakhs

Difference between the two options at age 60: **Rs. 25.5 lakhs** while the difference in the amount invested is only **Rs. 1.2 lakhs.** The goal of compound interest is to make your money work hard for you. The key step in using compound interest is to actually start saving. You don't have to save a lot – just save what you can. Compound interest will do the rest of the work for you. Compound interest is so fascinating that Albert Einstein referred to it as "magic" calling it "The most powerful force in the universe."

Asset Allocation

Asset allocation is based on the idea that in different years a different asset is the best performing one. It is difficult to predict which asset will perform best in a given year. Thus, although it is appealing to try to predict the "best" asset, proponents of asset allocation consider it risky. They say that one who "jumps" from the one asset to another may easily end up with worse results than any consistent plan.

Studies have pointed out that replacing active choices with simple asset classes worked just as well as, if not even better than, professional fund managers. The study also pointed out that a small number of asset classes ere sufficient for financial planning. This study supports the idea that asset allocation is more important than all other concerns like market timing, finding the right asset class every year, stock selection, etc.

Let's begin with a few snapshot data. In 2000, the Sensex gave you a -26.1% return, Gold -3.33% while Debt Funds gave a +10.19% growth. But in 2006, it was +46.7 for Sensex, +5.28% for Debts and 35.0% for Gold. Every year, there's a different growth story for the three asset classes, and nobody knows for sure what 2013 or 2014 or 2020 will give returns on the three asset class. If the papers tell you that Debt funds are doing well and you take out your equity investments and put them into Debt, chances are that the equity is back to performing well and the debt funds nosedive. If nobody knows when and what returns will an asset class give, jumping from one asset class to the other is really a bad idea, right?

How to set up your Asset Allocation?

Essentially Asset Allocation is your Investment policy. Depending on your own understanding of your risk profile, you need to finalize the best fitting pie for your debt, equity and other investments. To start off, the thumb rule of asset allocation is based on your age. So if your age is X, invest X % in debt and 100-X% in equity. If you are a 25 year old guy, invest 25% in debt and 75% in equity. Always remember, it's just the thumb rule.

Financial Planning Process

Step 1: Understand Yourself

There's always a risk-return trade off. You must know whether you can absorb the shocks of short term losses when you aim at higher returns. It's not possible that you want attractive returns and you are not exposed to a few shocks here and there. So be aware of your risk profile to start with. The three broad categories of risk profile are: Aggressive, Moderate and Conservative. Which one is your risk profile?

Step 2: Understand the Asset Classes

We must invest in assets we understand. Blindly investing in any of them could be disastrous especially equity. So one should know what options are available under equity and debt assets (see details of debt and equity classes in chapter VII) and then take a reality check on our comfort level with them.

Step 3: Decide your allocation ratio

Now you knew the thumb rule that if you are a 25 year old guy, invest 25% in debt and 75% in equity. But after going through steps 1 & 2, it's time you set an allocation ratio for yourself. You should allocate according to your risk appetite and not because of some thumb rule. Moreover, you can also allocate funds for equity classes like gold and real estate too.

Step 4: Balance the Portfolio

We need to monitor the portfolio and rebalance it to the original allocation ratio. Why? Well, once you have invested (for e.g.) Rs. 1,00,000, Rs. 50,000 in equity and Rs. 50,000 in debt funds the portfolio will change it's ratio over time. In a few months, the equity portfolio may be valued at Rs. 75,000 and debt portfolio at Rs. 55,000, total Rs. 1,30,000. (just an example). So if you want to maintain your asset allocation ratio of 50% each, you may have to sell Rs.10,000 from your equity and invest the same in debt to make them valued at Rs. 65,000 each. By maintaining this asset allocation ratio, you are booking profits when the equity markets rise. Similarly, you are buying more equity when the stocks go down, thereby reducing your cost of your stocks acquisition. This is what asset allocation can do for your financial health.

Financial planning is a critical exercise in ensuring long-term financial security. A financial plan is a road map to help you achieve your life's financial goals.

Here are three basic questions that you will answer during financial planning:

1. Where are you today? What is your current financial

situation?
2. Where do you want to get to? What is your vision of your future financial situation?
3. Will you be able to get there? How do you plan to achieve your vision?

During the financial planning process you analyse what your financial needs and goals are. Then, you quantify in money terms what resources you need to meet those goals, and quantify the time period during which you want to achieve these goals.

Investing Mistakes

In the investing journey, there are some common mistakes that if avoided, can make a big difference. Some of the common mistakes done by investors are listed as follows:

- Taking personal loans beyond capacity of repayment.
- Mixing insurance with investments
- Investing without a proper asset allocation
- Taking huge loans to fund real estate purchases
- Investing for long term goals without creating a contingency fund & planning for short term goals
- Over-diversification in case of mutual fund schemes (investing in too many MF schemes)
- Investing in direct equity/ derivatives without adequate knowledge/ professional advice and also inclination
- Investing out of line with one's risk taking ability
- Not tracking the portfolio performance on a periodic basis & sticking with poor performing schemes
- Investing in instruments which give a negative real return (i.e. return after adjusting for inflation) like Fixed Deposits
- Investing without an eye on tax efficiency of investment (for e.g. a person in a 30% tax bracket is better off investing in debt mutual funds than fixed deposit, in view of taxability)
- Investing when markets are high & redeeming when markets are low (not investing systematically)
- Locking all money in long term products (e.g. PPF, life insurance policies etc.) – as a result when money is required in short term, one is forced to take a personal loan

You may well check if you are presently making these mistakes & if yes, take corrective action in time else simply prevent making these mistakes. Also we need to review and ensure that unnecessary & non-performing investments are weeded out, wherever your money is lying is obtained, and your financial portfolio is simplified for better monitoring & tracking.

- Close unnecessary bank accounts especially the salary account once you've changed jobs.
- Transfer your EPF balance from previous employers
- Close unnecessary MF folios
- Correct your e-mail ID and other details in your investments
- Update your change of address and/or residential status in your investments / insurance policies
- Close unnecessary credit cards and debit cards
- Close any unnecessary ECS mandates given on your bank account.

Management parable that stimulates lateral thinking from "Your Sacred Self" by Dr. Wayne Dyer.

In a mother's womb were two babies. One asked the other: "Do you believe in life after delivery?"
The other replied, "Why, of course. There has to be something after delivery. Maybe we are here to prepare ourselves for what we will be later."
"Nonsense" said the first. "There is no life after delivery. What kind of life would that be?"
The second said, "I don't know, but there will be more light than here. Maybe we will walk with our legs and eat from our mouths. Maybe we will have other senses that we can't understand now."
The first replied, "That is absurd. Walking is impossible. And eating with our mouths? Ridiculous! The umbilical cord supplies nutrition and everything we need. But the umbilical cord is so short. Life after delivery is to be logically excluded."
The second insisted, "Well I think there is something and maybe it's different than it is here. Maybe we won't need this physical cord any more."
The first replied, "Nonsense. And moreover if there is life, then why has no one has ever come back from there? Delivery is the end of life, and in the after-delivery there is nothing but darkness and silence and oblivion. It takes us nowhere."
"Well, I don't know," said the second, "but certainly we will meet Mother and she will take care of us."
The first replied "Mother? You actually believe in Mother? That's laughable. If Mother exists then where is She now?"
The second said, "She is all around us. We are surrounded by her. We are of Her. It is in Her that we live. Without Her this world would not and could not exist."
Said the first: "Well I don't see Her, so it is only logical that She doesn't exist."
To which the second replied, "Sometimes, when you're in silence and you focus and listen, you can perceive Her presence, and you can hear Her loving voice, calling down from above."

May be this is one of the best explanation to the theory of 'After death' and the concept of 'GOD'.

AMAZING MATHEMATICAL MYSTERIES

1 x 8 + 1 = 9	1 x 9 + 2 = 11	9 x 9 + 7 = 88	1 x 1 = 1
12 x 8 + 2 = 98	12 x 9 + 3 = 111	98 x 9 + 6 = 888	11 x 11 = 121
123 x 8 + 3 = 987	123 x 9 + 4 = 1111	987 x 9 + 5 = 8888	111 x 111 = 12321
1234 x 8 + 4 = 9876	1234 x 9 + 5 = 11111	9876 x 9 + 4 = 88888	1111 x 1111 = 1234321
12345 x 8 + 5 = 98765	12345 x 9 + 6 = 111111	98765 x 9 + 3 = 888888	11111 x 11111 = 123454321
123456 x 8 + 6 = 987654	123456 x 9 + 7 = 1111111	987654 x 9 + 2 = 8888888	111111 x 111111 = 12345654321
1234567 x 8 + 7 = 9876543	1234567 x 9 + 8 = 11111111	9876543 x 9 + 1 = 88888888	1111111 x 1111111 = 1234567654321
12345678 x 8 + 8 = 98765432	12345678 x 9 + 9 = 111111111	98765432 x 9 + 0 = 888888888	11111111 x 11111111 =123456787654321
123456789 x 8 + 9 = 987654321	123456789 x 9 +10= 1111111111		