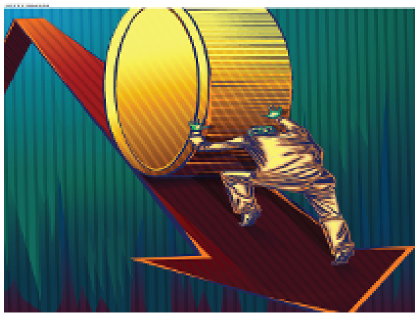
How to manage your financial goals amid falling returns on investments

By *Narendra Nathan*, ET Bureau | Oct 31, 2016, 07.27 AM IST



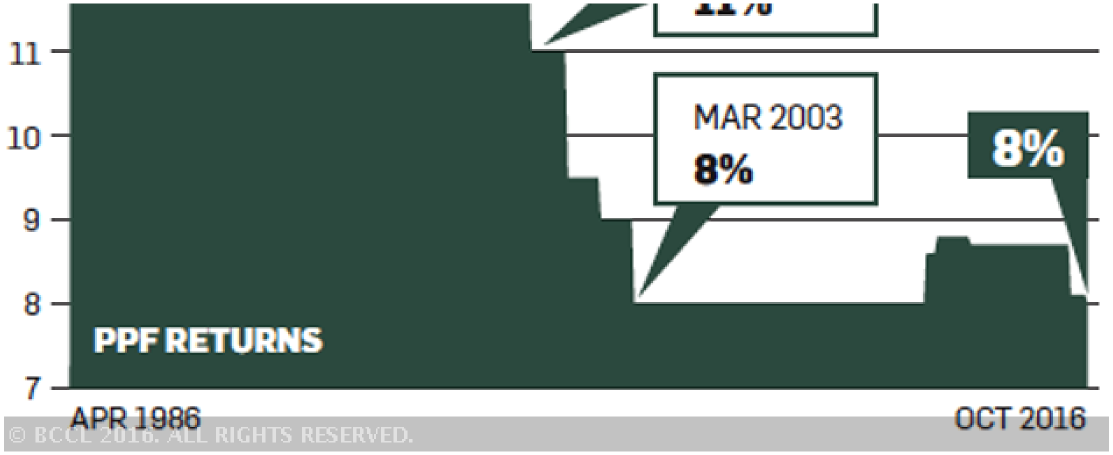
Cutting investment costs, taking calculated risks and tax-efficient investment choices will help in managing your goals amid falling returns.

Banks have started reducing their fixed and recurring deposit rates after the Reserve Bank of India reduced its benchmark rates by 25 basis points in the recent policy review.

From 1 October, the government also reduced the interest on small-savings products. For instance, Public Provident Fund (PPF) rate was cut from 8.1% to 8%—the lowest in the past 30 years. Since the government had already cut the PPF rate from 8.7% to 8.1% in April, the cumulative fall in PPF rate, this year, has been 70 basis points.

PPF won't help meet goals

Falling rates widen the gap between expected and actual corpus



PPF ACCOUNT OPENED IN	PREVAILING INTEREST RATE	EXPECTED CORPUS ON MATURITY	ACTUAL CORPUS ON MATURITY	SHORTFALL
2000-1	11%	₹22.91 lakh	₹18.12 lakh	20.9%
2015-16	8.70%	₹18.7 lakh	₹16.36 lakh*	12.5%

** The PPF rate is being linked to the government bond yields, which have dipped in recent months and could fall further. The calculation assumes an average PPF rate of 7.25%.*

There is a clear trend and rates will continue to fall in the coming quarters, say experts. “Small savings schemes used to provide higher returns earlier. But, investors should note the structural changes taking place. These rates will come down further,” says S. Sridharan, Business Head, Wealth Ladder Investment Advisors.

So, how big a cut should one expect in the near future? “Savings rates could come down by around 50 basis points in the next one year,” says Vishal Dhawan, CEO, Plan Ahead Wealth Advisors. There are two primary reasons why rates are falling. One, the government wants to link small-savings rate with that of government securities of similar maturity. For instance, PPF rates will be benchmarked against the 10-year bond yield. While the last 10-year yield is placed at 6.75%, its one-year average is placed at 7.46%, both significantly lower than the 8% interest rate on PPF. Two, banks continue to demand reduction in the small-savings rates and cite it as the biggest impediment in their transmitting RBI's rate cuts to retail borrowers.

The last Budget papers also referred to high returns on small savings as a 'subsidy for the rich'. However, cuts in small-savings may not be uniform across all such schemes. "While some targeted products such as the Senior Citizen Savings Scheme and the Sukanya Samriddhi Yojana may be spared, the axe may fall more on general products such as the PPF," says Dhawan.

"With yields on three-month certificates of deposit and quality commercial bonds placed at 6.5% and 6.65% respectively, investors need to moderate their return expectations": Dwijendra Srivastava, CIO, Debt, Sundaram Mutual Fund

Though not yet visible in the long term historical returns, debt fund investors also need to take note of this structural change. With short term rates falling sharply, the pressure has already started building up on short-term accrual funds. "With yields on three-month CDs (certificates of deposit) and quality commercial bonds placed around 6.5% and 6.65% respectively, investors need to moderate their return expectations," says Dwijendra Srivastava, CIO, Debt, Sundaram Mutual Fund.

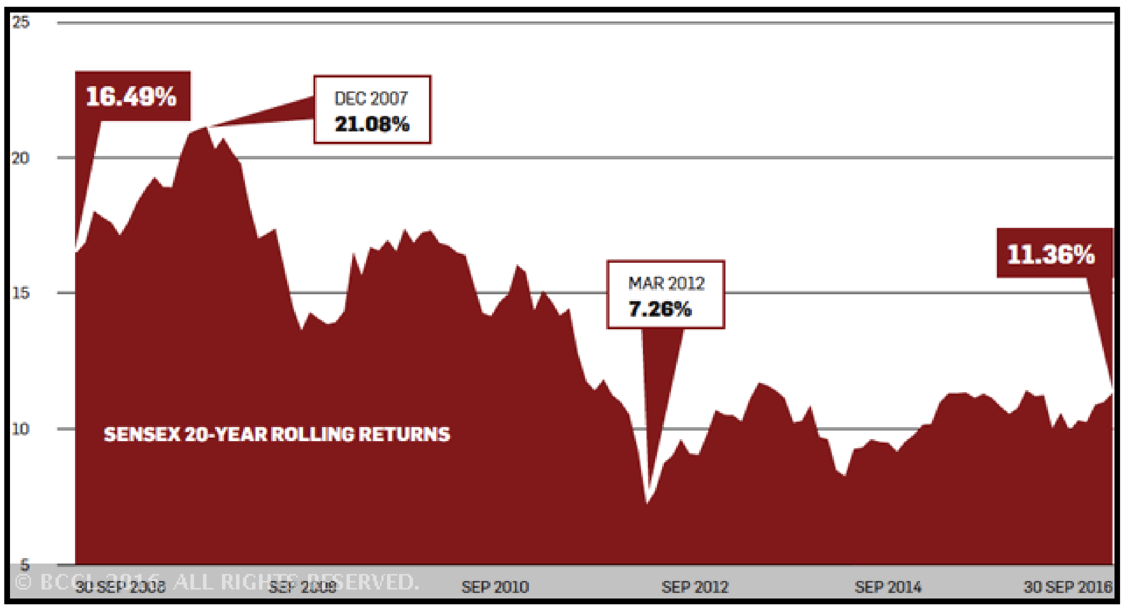
Experts say that investors need to moderate return expectations from equity

Experts say that investors need to moderate return expectations from equity too. If one sees the long-term returns from Indian equities, as of 30 September, the 20-year Sensex rolling return stands at just 11.36% (see: Diminishing returns from equity)—significantly lower than the 20% return generated between 1987 and 2007. We have not factored in dividend yield as retail investors can invest in the Sensex only through index funds and, historically, costs of index fund have offset the dividend yield.

There are two main factors behind this fall in equity returns. First, the Indian market is maturing and, so, future returns will be even lower. Historically, earnings growth and stock market returns used to mirror the nominal GDP growth—real growth plus inflation—of around 15-16%.

Diminishing returns from equity fall in inflation will cut future expenses

Currently, the 20-year Sensex rolling return stands at just 11.36%, almost half that of the preceeding 20 years.



Due to structural changes in the economy, investors need to moderate their *return expectation from equities.*

Since nominal growth now has come down to around 12%—7-8% GDP growth plus 4-5% inflation—the equity return expectation also needs to be brought down from yesteryears' 15-16% to around 12%.

"When the inflation is expected to be around 4-5%, equity return of around 10-12% is reasonable and gives enough compensation for the risk premium," says Ritesh Jain, CIO, Tata Mutual Fund.

So, expecting equities to give as high a return as in the past will be a big mistake. It is akin to assuming that PPF will continue to earn 12% return just because it has was so in the past.

Since the fall in inflation is the main reason behind the fall in returns for debt and equity investments, we need to find out if the fall in inflation is structural or cyclical.

Experts say, it's the former. "We are in the 'Uber phase' and, with the increasing popularity of 'sharing', the demand for new products will be low and this will keep inflation under control.

So, the forward looking return expectations from financial savings also have to come down," says Jain. And this is not just a problem facing Indian investors.

"Global pension funds and insurance companies are also facing the problem of falling returns," says Manoj Nagpal, CEO, Outlook Asia Capital.

Given this structural fall in returns across debt and equity asset classes, here's what you should be doing to secure your financials.

Review goal planning

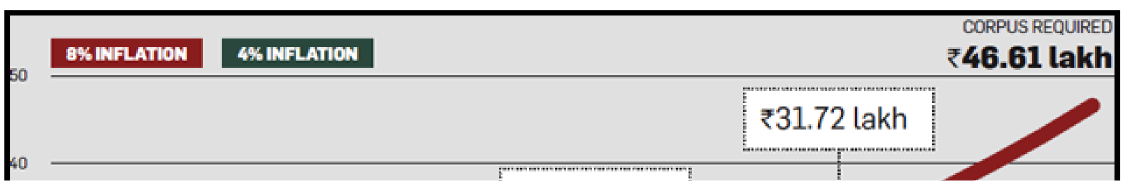
To start with, take a re-look at the inflation and return assumptions you made at the time of charting your financial plan. "Most retirement planning models take into account 15-20% equity returns.

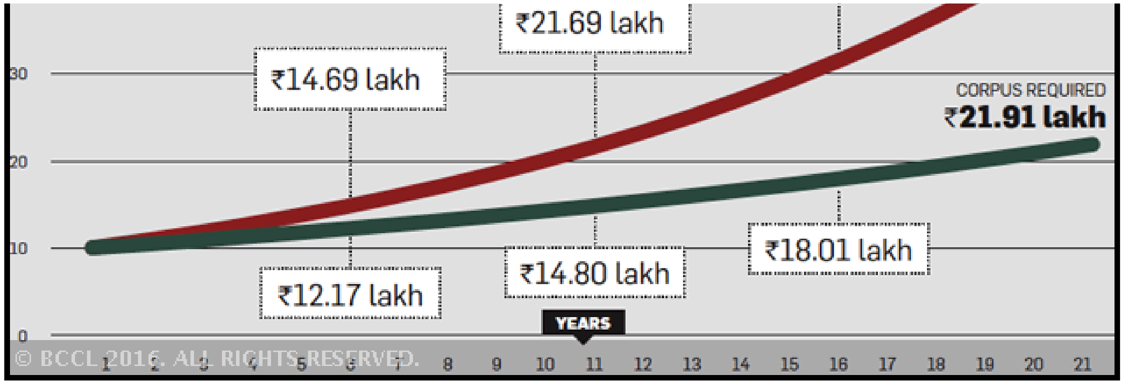
They need to adjust to the new normal and bring down the expectations," says Jain. Don't forget to cut down the inflation estimates too.

"The required amount for meeting a goal at a future date will also come down in a low-inflation environment," says Sridharan. The difference between the corpus required to meet goals at 8% and 4% inflation increases significantly with time.

Fall in inflation will cut future expenses

If inflation halves, the funds required to meet a goal 20 years later will be reduced by more than 50%.





Due to moderation in inflation, a sizeably smaller corpus would help meet future goals.

A goal requiring Rs 10 lakh currently will require Rs 46.61 lakh 20 years later, assuming an average annual inflation at 8%. However, if inflation falls to 4%, the corpus required will more than halve to Rs 21.91 lakh.

Similarly, the return expectations also need to be tweaked. For instance, a monthly investment of Rs 6,600 at 15% growth rate would have created a corpus of Rs 1 crore after 20 years but, in view of falling returns, you will now need to invest much more. At an expected 12% return, you will need to invest Rs 10,000 to generate a Rs 1 crore corpus in 20 years. To get a realistic idea on returns you need to pare down both inflation and return expectations.

Increase savings

Once you recalculate the corpus required to meet your goals, the next step is to see whether you are saving enough to create the corpus. Though reducing or scrapping some goals is an easy option, experts tell you not to do so. “Most Indians keep their goals at conservative levels, so reducing the corpus required is not the correct alternative. Instead, investors should cut down excess or discretionary expenses and save more,” says Nagpal. “You can also increase the savings rate by prepaying high cost loans (where the cost of loan is more than the return you are getting elsewhere)," says Dhawan.

Tweak risk profile

Since the overall return structure is coming down, investors also need to adjust their investment pattern to maintain their portfolio returns at current levels. This can be achieved by increasing the risk profile a little. For example, investors who are totally into debt can take some duration risk by investing in long-duration bonds or take credit risk by investing in medium quality bonds.

"If investors chase high-risk products like low-rated bonds due to their obsession with high returns, it can result in big losses": Rajiv Bajaj, Vice-Chairman and Managing Director, Bajaj Capital.

Mutual fund investors can do the same by getting into long-duration funds or mutual funds with a slightly higher credit risk profile. Tweaking your risk profile, of course, does not mean throwing caution to the winds. You need to be careful when taking additional risks. "If investors chase high-risk products, such as low quality bonds, without proper risk management measures, due to their obsession with high returns, it can result in big losses," warns Rajiv Bajaj, Vice-Chairman and Managing Director, Bajaj Capital.

"To generate better returns in the future, investors need to take active calls depending on the market situations," says Srivastava. Since taking timely action on duration and credit risk is difficult for the retail investors, it is better they give this mandate to professional fund managers by investing in dynamic bond funds. Another way to generate a better return is by increasing exposure to equity. This won't increase your risk profile by much, say experts. "Since the

Indian economy is maturing, it is not just the return that is coming down, but the risk as well," says Sridharan.

However, investors should be cautious when increasing their equity exposure. "While investors need to increase the equity exposure to generate better returns, they need to moderate the risk by doing it gradually (through systematic investment plans or systematic transfer plans)," says Dhawan.

Focus on investment costs

Indian investors, in the past, have often overlooked their cost of investment because of high returns. You can't afford to do that anymore. The impact of the costs will be much sharper now, especially for investments in debt funds. "Since the return profile is coming down, investors need to closely look at the expense ratio of the accrual funds," says Dhawan. Similarly, equity fund investors also need to concentrate on low-cost investment products such as exchange traded funds (ETFs). "In addition to low costs, there will be several innovatively crafted ETFs in the future and this will help investors switch among investment themes," says Dinesh Rohira, Founder and CEO, 5nance.com.

Increase financial know-how

"The period of everyone making easy money from vanilla asset classes is over now," says Rohira. Investors need to increase their financial understanding to make use of complex products that can help generate higher returns. Though several structured products are already available, they cater mostly to the high net worth investors (HNIs). "Due to the democratisation of structured products, they will be available to the common investors too in the future," says Rohira. However, investors need to understand these complicated products before investing. High cost is another issue associated with bundled products right now. "Avoid all bundled and structured products that you don't understand. Also, invest in them only if the cost is low," says Bajaj.

Factor in taxation

Factor in taxation

Investors in high tax-brackets can increase their net income by reducing their tax liability. For example, they can shift a part of their debt portfolio from tax-inefficient fixed deposits (FDs) to debt mutual funds. “Since debt funds, after three years, qualify for long-term tax benefits, it makes sense to shift from FDs to debt funds,” says Bajaj. The post-tax money you get in hand will be substantially higher, if you invest in debt funds.

Cut tax for better returns

Debt fund are a tax-efficient alternative to bank fixed deposits.

	FIXED DEPOSIT	DEBT FUND
INVESTMENT	₹1 lakh	₹1 lakh
3-YEAR RETURN*	₹22,500	₹22,500
INDEXATION BENEFIT*	N/A	15,760
NET GAIN	₹15,760	₹6,740
INTEREST TAX AT 30%	₹6,750	N/A
TAX ON NET CAPITAL GAIN AT 20%	N/A	1,348
NET CASH IN HAND AFTER 3 YEARS	₹1,15,750	₹1,21,152

*Assuming a 7% return and 5% inflation

People in high tax bracket can increase their post-tax return by shifting from FD to debt funds.

Lock-in rates

Though banks have started cutting FD rates, some lenders’ rates are still attractive, so investors in the lower tax bracket can look to lock-in those FDs. If you don’t have enough money right now, you may opt for the recurring deposit you don't have enough money right now, you may opt for the recurring deposit (RD) route to do so. "The main advantage of an RD is that investors can lockin the current rates and invest their future cash flows at the locked-in rate," says Dhawan. Those in the higher tax brackets can do the same with tax-free bonds. "Investors who are in the high tax brackets and want to lockin the current yield can do so by buying taxfree bonds from the secondary markets," says Bajaj. The secondary market yields on most tax-free bonds are between 6% and 6.5% now. Mutual fund investors can invest in fixed maturity plans (FMPs) before the yield on debt instruments falls further.

For the retired

The analysis here is complicated because the concept of real return—over and above the inflation rate—is only partially applicable to retirees. The hit taken by retirees because of the fall in inflation and fall in returns is huge.

Retirees need to rethink

To offset low returns, retirees need to increase their exposure to equities.

CURRENT FINANCIALS	NEXT YEAR'S FINANCIAL OUTLOOK	
Retirement fund: ₹1 crore	**At 7% inflation & 9% returns**	**At 5% inflation & 7% returns**
Expenses stand at **₹7 lakh**	Expenses will rise to **₹7.49 lakh**	Expenses will rise to **₹7.35 lakh**
Income at **9%** return: **₹9 lakh**	Income will stay the same: **₹9 lakh**	Income will sharply fall to **₹7 lakh**

Retired people will take the biggest hit due to this structural change—low inflation and return.

Though their expenses move up by a lower percentage, the reduction in income due to fall in returns are drastic. "The only option left to retirees in a situation like this is to enhance their return profile by increasing their equity exposure a little. Retirees in their sixties should increase equity allocation to 30% from the normal 20%," says Sridharan.

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