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WHAT IS YOUR REAL RATE OF RETURN?

consumer price inflation prevailing in the economy plays an important role. Investors should aim for a higher positive real rate of return so that they do not run short of funds as they age.

Secondly, specifically in cases of planning for retirement portfolios, it is important to know that one has to plan for a few decades. Most banks may offer you attractive FD rates for your money but at the most those attractive rates would be offered by banks for a couple of years at best. No bank is offering you a 20 or 30 year FD.

This therefore means that on renewal of these FD investments the rate of return that you may be offered shall be lower than today (in the given interest rate scenario). This risk that you face as an investor is called reinvestment risk. This means that the real rate of return earned today by an investor may not remain so in the coming years.

These examples given are not to discourage the use of FDs by investors, but to illustrate by example that this myth that FDs can be the one and only solution for investor portfolios may not work especially where investors may be underfunded and may be seeking greater corpus for retirement and/or other milestones.

So given the above facts, what can one do to get a positive real rate of return?

Diversification is important: Investors need to understand that they can have different parts of their portfolios with different risk return profiles catering to their various milestones. For example – If an investor is investing for retirement which is a decade away, he/she can very well look at investing a portion of his funds in high growth asset classes such as Equities and/or Real Estate, in addition to having funds in FDs, PPF, bonds. This could boost the overall rate of return.

Equities are risky, but return is always tied to risk: Equities and Real Estate as asset classes have the potential to generate higher real rate of returns. Equities as an asset class in particular, reflects the growth rates of the corporate sector of the economy. Assuming that corporate India shall continue to show growth in the coming years, this asset class could have the potential to generate higher nominal growth rates and therefore higher real rates of return.

AS TAX DOES EAT INTO YOUR NOMINAL RATE OF RETURN, USING TAX EFFICIENT INVESTMENT AVENUES SUCH AS STOCKS, EQUITY MUTUAL FUNDS AND DEBT MUTUAL FUNDS COULD ALSO ENHANCE YOUR REAL RATE OF RETURN. GAINS ON STOCKS AND EQUITY MUTUAL FUNDS HELD FOR MORE THAN ONE YEAR ARE TAX FREE.

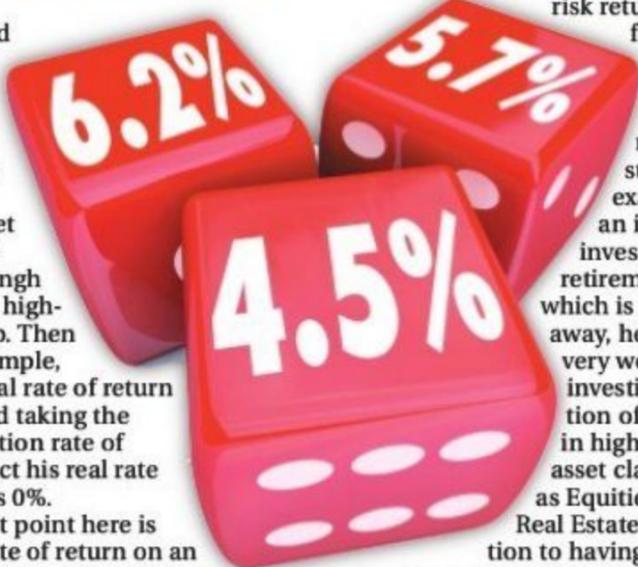
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Use Tax efficient investment avenues:

As tax does eat into your nominal rate of return, using tax efficient investment avenues such as stocks, equity mutual funds and debt mutual funds could also enhance your real rate of return. Gains on stocks and equity mutual funds held for more than one year are tax free. Similarly debt mutual funds held for more than three years get indexation benefits thereby reducing the tax incidence and enhancing returns.

Overall, depending on the risk appetite and investment horizon, investors whether young or old, could potentially make higher real rates of returns on their investments by investing wisely keeping the above items in mind. (Client names changed to keep client confidentiality)

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Since the announcement of demonetisation of 500 and 1000 rupee notes, there are expectations of banks being temporarily flush with funds thereby leading to a drop in FD rates. India was already on a low inflation trajectory and with this announcement the downward trajectory path seems to be set. So, what does all this mean for investors who depend on FDs and other fixed income products for their monthly income and investments.

To site an example, I would like to narrate a recent interaction with my client Mr. Kumar. We were planning his retirement portfolio, when he immediately commented "I have a big enough FD portfolio invested in 2015 which is fetching me 7.75% p.a. This FD portfolio will take care of my retirement. Why do I need to invest elsewhere?" This is a common comment that we as financial planners and advisors hear. There are many

SHALINI DHAWAN explains the impact of recent demonetisation on investors who depend on FDs and other fixed income products for their monthly income and investments

assumptions and misconceived notions here in this simplistic assumption that an 'FD only portfolio' will take care of retirement. Let us delve into them.

First and foremost, let us understand the real rate of return that Mr.

Kumar is earning on this FD investment. In simple terms, the real rate of return is the nominal rate of return less the prevalent inflation rate. For example – if Mr. Kumar FD was earning 7.75% p.a and average inflation for 2016 was at 5.7% then Mr. Kumar's real rate of return is 2.05% p.a. In case if inflation were higher as is usually the case with consumer items, then his real return would be lower. Another important point here is that this real rate is short lived as since Mr. Kumar's FDs are due to mature, the 5 year FD rate he will now get is approx. 6.75% reducing his real rate to 1.05% p.a.

Another example of a client, Mr. Singh, comes to my mind. In his case, he was very satisfied and told me that he had invested a big amount of funds in a FD with a bank in 2015 which was offering him 8.25% interest. He was assuming that getting a good FD rate is all that was needed and had totally forgotten

that he had not even considered the taxation impact on this FD income. Let us assume that Mr. Singh was in the highest tax slab. Then in this example, his nominal rate of return is 5.7% and taking the same inflation rate of 5.7%, in fact his real rate of return is 0%.

The moot point here is that the rate of return on an investment is not to be taken at face value as in the case of Mr. Kumar and Mr. Singh. The rate of return would be eroded by tax and inflation at all points in time and therefore your tax slab as well as the

