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MONEY MATTERS

# FIVE INVESTMENT MYTHS

As in life, so in investing, Indian investors harbour a number of myths that prevent their portfolios from achieving their highest potential. Our columnist winnows the grain of reality from the chaff of superstition

VISHAL DHAWAN

WE SAT around the room, bedecked in wedding finery, waiting for the black cat that had crossed the bride's path to retrace its steps, post which we too would have to retrace ours. "Shalini," I said to my wife, "are myths of this kind prevalent everywhere?" She replied, "Yes, of course, even in a profession as staid as yours — financial planning." While my first reaction was "Of course not", it got me thinking. Could it be true? Mulling over my experiences with clients, I tried to think of investing myths I may have encountered. To my surprise, I could think of not one but several, and so decided to jot them down on my Blackberry.

**Myth 1.** How can I take any risk with the money meant for my children's education? This is the one I come across most often, as parents of newly-born children go about putting the cash gifts received from relatives and friends into bank deposits and traditional insurance plans that offer low returns.

**Reality.** Since the investment horizon (the time till your child goes to college) is quite long, empirical evidence suggests that equities would be the most appropriate asset class to use for achieving this goal. As the time for your child to attend college draws near, it would be prudent to begin moving the funds from equities to fixed-income instruments, and thus reduce the risk that a sudden downturn in the market might jeopardise his prospects.

**Myth 2.** Everytime I invest in the stock market, it goes down. This is akin to a lot of people believing that India will lose a cricket match if, during a close encounter, they leave the drawing room.

**Reality.** Historical data indicates that over the last 30 years, if investors looked at their portfolios after a year, their chances of seeing a negative return would be close to 40 per cent. However, if they looked at their portfolios after five years, their probability of seeing a loss would drop to below 15 per cent. And it would be close to zero if they looked at their portfolios after 10 years.

Illustration: ANIRBAN BORA

**Myth 3.** It is always better to pay off loans before investing. As the punch line of an ad for a financial services product goes: "*Tension kum hoga to aadmi zyada jiyega na*."

**Reality.** Since most loans are monthly reducing-balance loans, the interest component tends to be much higher during the early phases of a loan. Therefore, prepaying in the early part of a loan works to your advantage. However, as a loan progresses, and more of the principal gets repaid in the EMI, it would be prudent to ask your financial planner if it still makes sense to pre-pay. Or should you invest in an instrument that could generate a higher return without any significant risk? You would be surprised to note that there are points when even a bank deposit will earn you a higher return than the tax-adjusted cost of your home loan. This holds true provided you see no risk to your future income flows.

**Myth 4.** It's too early to start saving for retirement now. I will start after a few years. After all, my friends who earn less than me seem to spend more.

**Reality.** The Red Indians sold the whole of Manhattan in the 1600s for $24 and most people believe that was a terrible decision. However, the $24 compounded at 8 per cent would have been worth $30 trillion a few years ago. The entire real estate in Manhattan was then worth just $56 billion. That leaves the Red Indians smarter by $29 trillion and a little more. No wonder Albert Einstein called compounding the most powerful force in the universe. Investors should start saving for their retirement at a young age, even if the amount is not significant.

**Myth 5.** It is not worth earning just 3-5 per cent extra per annum if you are going to take on extra risk.

**Reality.** Rs 10,000 per month invested for 25 years would grow to Rs 95 lakh at an 8 per cent rate of return, but to Rs 2.2 crore at a 13 per cent rate of return. Thus, instead of growing a little over two times in 25 years, your money grows more than eight times if it compounds at the higher rate. While it is important not to invest without due diligence in a scheme that promises a higher return, there are enough investment opportunities with marginally higher risk that can multiply your money much faster. So the next time you decide to invest, remember that a little extra return can go a long way.

"Come on, join the dance. There you go with your Blackberry again." It was my wife chiding me. By then the black cat had wandered away and the marriage celebrations were back to their noisiest best. ◆

*The author is a financial planner and founder of Plan Ahead Wealth Advisors.*
*Email: vishal@planaheadindia.com*

## The bottomline

- Since the time horizon available to you before you need the funds for your children's education is very long, these funds should be invested in equities
- If you invest your money in a diversified basket of equities and look at the returns after 10 years, your chances of getting negative returns are close to zero
- In some circumstances, it may be smarter not to prepay the loan, and deploy your surplus funds where they can earn higher returns
- Start saving for your retirement at an early age, even if the amount saved is small. The power of compounding will help augment the size of your portfolio
- A little higher returns make a substantial difference to your portfolio in the long run, thanks to the power compounding