Ignore pension plans at your own peril

GET PERSONAL

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INVESTORS NEED to align their tax planning strategy with their long term financial goals as well.

Taxpayers today have a plethora of options to choose from to invest the Rs 1 lakh they are permitted under Section 80C.

One category that gets little attention in tax planning is pension plans. Apart from tax saving, long term investments such as these are also important from the retirement planning perspective. These plans are a mix of debt and equity, and therefore offer a mean between a high risk equity strategy and a zero risk debt investment.

The normal request that we hear at this time of the year is "My tax consultant has asked me to invest Rs 70,000 into my PPF account and explore other options for the rest — what do you recommend?"

PPF continues to remain an attractive option given the 8 per cent tax free return. However, it can't be the only investment avenue either, as this may not keep pace with inflation in the long term, and the real returns can be negative. A good investment strategy should be able to balance the tax planning requirements with financial goals as well.

This alignment can be done in two ways.

The first is to purchase products that mix debt and equity. There are pension plans offered by some insurance companies and mutual, which have a predecided mix of debt and equity, usually in the ratio of 60/40. However, the one size fits all approach may not work for everyone. You may want to plan your investments depending upon your requirements, which would also change with time.

The factors that need to be considered here are:

■ AGE: Younger clients saving for the distant future can invest a larger proportion of their savings in equity instruments such as ELSS. Equities tend to outperform all other asset classes over the long term, but can fluctuate sharply in a short time period. So the allocation to equity can be high in the initial years and should be reduced every few years. A good ballpark is to cut the allocation to equity by 10 per cent every five years. So at the age of 40, the mix would be 70 per cent equity, 30 per cent debt. At 50, it would change to 50 per cent equity, 50 per cent debt. Considering the historically high inflation rates in India, some allocation to equity instruments is critical.

■ RISK PROFILE: You can raise the allocation towards debt or equity, depending on how much risk you are comfortable with. However, a 100 per cent debt strategy is a bad idea because it means negative returns.

■ FINANCIAL GOALS: For an investor planning for retirement, a pension plan may be a good choice as all investors coming into this category would have a similar objective of saving towards retirement, and hence the manager has the flexibility to create a long term portfolio.

■ EXISTING ASSET ALLOCATION: For an investor having a large contribution towards employee provident fund, it may not be advisable to put more monies into a PPF account, whereas a self employed individual could use the PPF as a contribution tool towards retirement.

For an investor with all assets already in equities or equity mutual funds, it may be prudent to balance his portfolio by using tax planning instruments with low equity exposure. It is critical for you to decide on whether you would like to use manufactured products with varying levels of debt and equity exposure.

In order to achieve this successfully, start your tax planning early from next year so that the decision on which instruments to buy can be driven by multiple factors, rather than decisions that are made on the basis of the tax benefits.

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