Focus must be on protection of purchasing power, not capital

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Inflation is the rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Inflation effectively burns the value of our money! Inflation is the presumptive tax on our returns we should be aware of. Hence, as investors, we need to focus not on 'capital protection' but on 'purchasing power' protection.

If a fixed income investment is giving a return of 10% and inflation is 7%, then our 'real-rate' of return is just 3%. Fixed income investments are the hardest hit by inflation. So to achieve long term financial goals, over a 10, 20, 30-year time-frame, we need to create a portfolio of investments that will be inflation-proof and provide positive 'real-rate' of returns.

Good rated company deposits, tax-free bonds and debt mutual funds are relatively low-risk fixed income options. These would just about give us a real rate of return over the longer term. EPF/PPF options should be fully exercised as they offer tax-free returns. Unless one requires regular income, one should take cumulative option in deposits and debt mutual funds to enjoy the full benefits of 'compounding'.

Compared to the Investments mentioned above, equities offer an inflation protected return over the longer term. As the input costs go up, mainly due to inflation, companies pass-on the inflated cost to the consumer. So the companies' revenues in aggregate broadly represent the economy itself. India's nominal GDP growth rate (real growth rate plus inflation) has been 14.1% per annum (pa) since 1979. Current GDP growth rates in the last three years (7.9% pa real growth and 8.1% pa inflation) have been approximately 16% pa. It is not surprising, therefore, that the sensex has yielded nearly 15% annual returns, that is positive returns after adjusting for inflation since its inception in 1979. One of the best ways to gradually add equities to one's portfolio is through systematic investments in equity mutual funds.

Real estate is also a good long term inflation hedger and investment multiplier. However, here one needs to keep in mind that real estate tends to be relatively illiquid, requires large initial investments and has high transaction costs.

Real assets like gold have also proved to be great inflation hedgers in the last few years, as most central governments have been on a money printing spree. Also, gold provides a hedge for Indians as it is an international commodity. It can be conveniently bought and held in the form of ETFs offered by fund houses.

In order to effectively meet our financial goals, we need to diversify our portfolio with investments which will 'protect' and 'increase' the 'purchasing power' of our hard-earned money over the longer haul.

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WHAT IS ON OFFER

Debt investments		Investments with potential for high capital appreciation
With fixed return	With variable return	
Bank FDs	Open ended debt MF	Equity
Company FDs	Closed ended structured debt MF	Gold
FMPs		Real Estate
Tax-free bonds		Commodities
PPF/EPF		

NEXT WEEK

Financial advisors and planners play a very important role in setting financial goals and then helping the investor execute a plan. Next week we will discuss the role that financial planners and advisors play and the recent developments related to this profession.