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Set a goal before investing

Just like when you go on a trip there is a destination, investing without a goal is like getting into a taxi and when asked "Where to go?", you cannot answer "I don't know, take me somewhere". Investing without a goal means investing in the wrong thing. So how to set goals?

1. Think about the future

- Career: salaried job, business, freelancing...
- Life 5, 10, 20 years from now
- How long do you want to work? Interested in FIRE?

2. Discuss with family

Investing for your family's future to build a financially stress-free life:

- Get family onboard
- Lifestyle: cars, homes
- Schools and colleges for children, their marriage
- Retirement planning (most important)

3. Revise goals based on life events

- Higher education (like MBA), skill enhancements
- Deciding to buy a house
- Marriage and children
- Illnesses and sudden changes like job loss
- Outlook changes and careers change: job to business or reverse
- Location shift: cities, countries / relocation / immigration

What if there are no immediate goals ?

Is having just "wealth creation" a valid goal?

- Your pre-requisites should be in place: emergency fund, term & health insurance
- if you are anxious to start, simply start a 50:50 investment in equity & debt funds

Jun 03, 2021

by @sayansircar

Jun 04, 2021

by @sayansircar

Investor behaviour: control what is possible

This piece deals with 4 situations that typically arise while making investments and what one should for each

Important things / Things under my own control
This area needs the most focus and needs to be planned / reviewed:

- Goal setting, asset allocation, risk management, rebalancing
- Emergency fund, Term and health insurance
- Debt re-payment plan: snowball or avalanche methods
- Conscious spending and planning big ticket purchases (car, house)
- Stop yield chasing (NCDs, credit risk MF, high duration debt MF)
- Keep taxes and costs low in investing (Direct growth index funds)

Important things / Things NOT under my own control: Outside factors that need to be acknowledged and impact minimized

- Taxation of assets (LTCG/STCG), lock-in of PF/NPS, stamp duty
- TER of Mutual funds
- Market factors: returns, volatility, interest rates, credit quality, rents
- Liquidity of assets: SGB, closed ended MF, real estate

Unimportant things / Things under my own control: People pay a lot of attention to this and they shouldn't

- Looking for the "best" funds / stocks / insurance without knowing purpose / goal / asset allocation first
- What is the best date for a SIP?
- Investing / buying a house only to save tax

Unimportant things / Things NOT under my own control: These are irrelevant in the bigger scheme of things

- Timing the market: waiting for the right time to enter / exit
- "Which day's NAV will I get?"

Understanding impact of risk on returns

Jun 05, 2021

Imagine this situation: There are three roads with varying amounts of traffic and same width. You are paid money proportional to the average density of traffic if you cross the road **blind-folded**.

The density is 10 cars/min, 50 cars/min and 100 cars/min and the payouts are expected to be 1000, 5000 and 10000 for crossing respectively.

You are an interviewer interviewing two groups of people: those who have crossed already and those who are yet to cross. The people who have crossed & made a lot of money **are those who took higher risk**. Based on the feedback of this group, **what would you recommend to the group that is yet to start?**

The group that got higher return (if we do not know how many times they crossed) got it **since they took higher risk**. However this **does not automatically imply** every one who tries crossing the highest-traffic lane blind-folded automatically gets the highest payoff. The risk of getting hit by a vehicle is a lot higher.

So just choosing the high risk path does not lead to high returns. In fact if that was the case, **the risk would be low and not high**.

The same logic applies in case of choosing asset classes in a portfolio. E.g. choosing **higher risk assets** like small cap funds and credit risk funds **does not guarantee high returns**. In the absence of prudent risk management (maybe some one is there on the other side of the road calling out to you to change course during the crossing) the result can be disastrous.

In investing, risk management is done via taking only the amount of risk suitable for the goal and as per the **minimum** of risk taking ability and willingness.

Once the portfolio is in-flight, the risk is managed actively via a **glide-path and rebalancing**.

by @sayansircar

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Investing during 2020 market bottom

Jun 06, 2021

Mar 23, 2020 was a rather unique day in Indian stock market. The day marked a 38% fall in the markets from 52 week high due to COVID-19 disruption. Seven-year SIPs were showing negative returns at this point leading to a lot of experts pushing SIPs change their definition of long-term to beyond 7 years.

This was followed by a massive rally that caused a doubling of the market in 11 months. All of this is measured against the Nifty 50. Small cap indices and funds demonstrated a sharper fall and meteoric rise. Some small-cap funds doubled.

Since hindsight is 20/20, many of us are regretting not buying the multi-baggers in March 2020. There are multiple problems here though:

- For many, there was massive uncertainty - health, family and job related - checking market levels was difficult
- What would have been the source of cash? No one on 23-Mar-20 was in a position to predict the bottom. There was talk of Nifty going to 6k levels. Some would have panicked early and sold in Feb/early-Mar and only a lot of conviction would have made them re-enter in March.
- Would you have dipped into emergency fund to buy stocks? Unlikely given the level of uncertainty in the market.
- Did you have an "opportunities fund" to take advantage of such opportunities? How big would such a fund have been given the implied cash drag? Ultimately any money you could have invested would have been likely a very small part of the overall portfolio (unless you were a new investor starting then)

So the returns would not have been as phenomenal as the price movements and index levels show.

Bottom line: It was a missed opportunity but not so big to beat yourself up for it. A better alternative will be to stick to your goals, follow asset allocation and review/rebalance regularly.

by @sayansircar

Does backtesting work in real life?

Jun 07, 2021

by @sayansircar

Backtests are typically used to support Tactical Asset Allocation or trading strategies based on technical indicators like moving averages, PE or risk.

Backtests are easy to present and understand but there are some challenges in the approach and practical implementation that need to be considered.

Backtests generally show returns and risk vs. a target benchmark, rolling XIRR and drawdowns from peak over time.

Backtests tell you what worked in the past but past performance is no guarantee of future performance. Market conditions, investor attention and overall trends will be different.

Another thing that backtests do not show is what investor will do when implementing a strategy. Many people start implementing a backtested strategy with a lot of enthusiasm till they see how much capital gains taxes they need to pay, specifically in implementing rule-based stock portfolios.

Backtests also do not capture a person's emotional state. What people feel when markets go up and down will impact what they actually do instead of what they should do:

- **Greed**: In a bull market, investors will tend to ride the trend hoping for more returns
- **Fear**: In a bear market, investors may either panic sell or take no action hoping for a recovery

Backtests have been criticized for “torturing the data” or overfitting till it fits a narrative and/or a pattern is found. Investors need to be aware of this and closely track if the strategy is working or not.

Index vs. active mutual debate is not about returns

Quick definition: An index fund is designed to closely mimic the returns of a benchmark index at a low cost while an active fund is supposed to give better returns than its benchmark.

Human behaviour provides another point of view on why investors should choose index not active. Normally there is a lot of focus on past returns and cost since it is very common to see articles and reports saying “in this segment index funds are beating active” or a variation of this theme.

Why invest in index funds? Index funds reduce active decision making by the:

- fund manager: what to buy/sell, entry/exit timing, sector weights – wrong active decisions will reduce returns
- investor: chasing returns based on past performance, investing in multiple funds in the same category, switching

Fund manager behaviour: The active manager spends considerable time and effort in beating the index. This results in higher fees (via expense ratio of the fund) but there is no guarantee that the fund will outperform its benchmark index

Investor behaviour and the factors that reduce return:

- **Fees**: Choosing multiple similar funds in the same category hoping one will outperform the index
- **Underperformance**: Investing based on past performance, especially after a run-up in certain segments or sectors
- **Taxes**: Frequently moving in and out of funds trying to find the next best fund
- **Unable to review:** Reviewing risk and return of active funds vs. their benchmark is a difficult task

Jun 09, 2021

by @sayansircar

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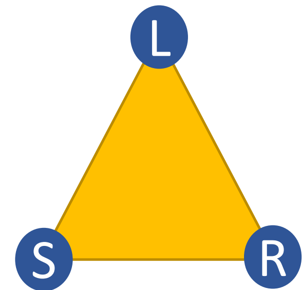
Liquidity triangle: why it is important when investing?

Asset allocation allows investors to choose various types of assets that has to be carefully judged along three qualities to ensure it meets the goal horizon and investor risk profile:

- **Liquidity**: this is a measure of how fast something can be converted into cash
- **Return:** this is how much price changes over time and measured using XIRR
- **Safety:** this measures if the current value will come back to the investor



When choosing assets for a goal, investors can maximize up to **two** of these **three** as shown below:

Asset	Liquidity	Return	Safety
Cash	✔✔✔	✔	✔✔
FD	✔✔✔	✔	✔✔✔
Gold jewellery	✔✔	✔	✔✔✔
Open ended MF	✔✔✔	✔✔	✔
NPS	✔	✔✔	✔
Real Estate	✔	✔	✔✔
Stocks	✔✔✔	✔✔	✔
Annuity	✔	✔	✔✔
Debt MF	✔✔✔	✔	✔
Sov Gold Bonds	✔✔	✔	✔✔✔
Provident Fund	✔	✔	✔✔✔

Note: the number of ticks is a relative measurement that does not change the conclusion of the liquidity triangle

Jun 10, 2021

by @sayansircar

What is the “goal” in retirement?

Retirement Goal: To have enough money every month for living expenses, healthcare, travel, gifting and entertainment. This is the same as pre-retirement life with the important distinction being not having a regular source of income from salary or profession.

Instead of that, the "income" comes by drawing down a corpus created when there was income which was the accumulation phase.

During retirement, there are two main things to do:

- Withdraw at most enough for the expenses
- Manage the risk of the portfolio via regular review and rebalancing

The first step is the same as the accumulation step with one change - instead of investing, you are redeeming.

The second step is also identical and serves the same purpose: ensure that the goal is on track and asset allocation is appropriate.

There are three big sources of risk in retirement:

- **Inflation**: expenses rising faster than the portfolio return
- **Longevity**: living too long and running out of money
- **Sequence of return risk**: A few bad years in the beginning can deplete the equity section of the portfolio

Here "goal-on-track" means at your current withdrawal rate adjusted for inflation, there will be a non-zero portfolio once retirement is over.

Having something left over in the portfolio allows you to pass on assets to heirs however if the portfolio drops to zero, you need to rely on other sources of income (children typically or a reverse mortgage)

Jun 12, 2021

by @sayansircar

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Emergency fund is your first line of defence against uncertainty

Jun 13, 2021

Purpose: An emergency fund is money kept aside to be used in case there is a sudden or unplanned expenditure or contingency. This money helps you sleep better at night knowing that it is there.

The fund is needed to be available for immediate use in emergency situations. Without this safety net in place, people will have to run around for money, depend on a loan or use a credit card with high interest. An emergency can be

- Medical emergency
- Vehicle accidents
- Sudden major repairs/theft
- Job loss
- Illness
- Due to Murphy's Law

What is a part of an emergency fund? Major monthly expenses items like

- Housing: rent / EMI
- Food, utilities, schooling
- Transportation costs
- Loan EMIs

How much to save?

		Monthly expenses		
Where to keep	**Multiple**	**20,000**	**50,000**	**1,00,000**
Cash in house	1x	20,000	50,000	1,00,000
Savings bank	5x	1,00,000	2,50,000	5,00,000
Liquid fund	6x	1,20,000	3,00,000	6,00,000
	Total fund size:	**2,40,000**	**6,00,000**	**12,00,000**

- 3x is minimum, 6x is normal
- 12x is recommended in high-risk scenarios (global pandemic, recession, job uncertainty, high medical risk situations)

Where to save and what not to do?

An emergency fund needs to be accessible during emergencies and is not the right place to look for returns.
Keep this money in cash, savings account and liquid mutual funds.
A high limit credit card can be used for temporary access to liquidity.

by
@sayansircar

Jun 14, 2021

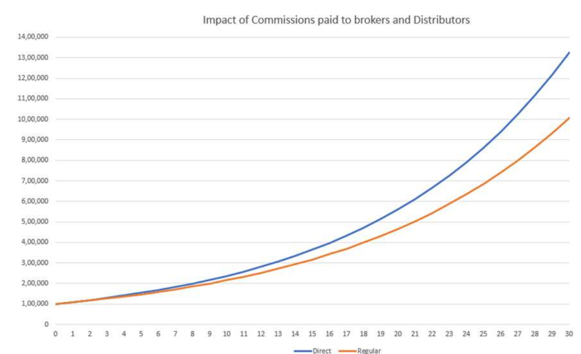
What are direct vs. regular funds and why you should only invest in direct?

Direct and regular mutual funds are the same funds with identical portfolio. They differ in the way expenses are calculated with regular having brokerage or commission built-in.

NAV = (Assets – Expenses)/Units_OutStanding, where expenses (TER) is the cost of running the fund and includes distributor commission. TER charged to the fund as a % of assets and NAV is calculated daily after subtracting the expenses. Regular expenses is higher than direct since the commission part is zero in Direct. This is why Regular NAV gives lower return and falls behind Direct after some time.

Here is an example with data from Valueresearch.com that shows the difference of return over 5 years.

Over 30 years, a 1% difference in TER leads to a more than a 30% difference in portfolio value. All else remaining same if the Direct investor ends up with 10cr, the Regular fund Investor will have less than 7cr. The difference is the commission paid over 30 years.



by @sayansircar

What is the best way to pay-off multiple loans?

If you have two or more loans, there are generally two strategies to pay them off:

1. Highest rate first: The strategy is to take the loan with the highest interest rate, like a credit-card balance or personal loan, and pay off as much as possible every month while making minimum payments on the rest like a home loan or educational loan

This minimizes both interest paid and time to pay off all loans

2. Lowest balance first: This strategy exists so that the borrower can feel a sense of accomplishment by getting rid of the loan with the lowest balance first while making minimum payments on the rest

Once that loan is repaid, then the process is repeated with the rest of the loans. This strategy gives relief to the borrower struggling with a lot of loans. This method will lead to substantially higher interest payments and longer payout times compared to the previous one

Like everything else, there is a middle path of these two extremes:

- Pay off the highest interest loan first if it is something like a credit card balance with very high rate of interest
- For the rest, approach a loan consolidation agency to combine the loans into one single loan
- Divert any available income from expense cuts, selling off unnecessary stuff or even a bonus at work towards an emergency fund. This builds a cushion to avoid future high-interest debt like credit cards used in emergencies

Jun 15, 2021

by @sayansircar

How to manage expenses and investments with irregular income?

If you have an irregular income (via freelancing, business or consulting) instead of a regular salary, use these techniques to spend, save and invest in a worry-free fashion.

We will show ways of smoothening your budget by creating multiple buckets for each area.

Spending:

- Monthly mandatory (X): maintain 3X in savings account for running regular household expenses. Imagine a bucket that drips out slowly and gets filled when there is a water supply in the house (aka income)
- Annual fixed (Y): This is stuff like insurance payments, trips, festival shopping etc. Estimate the annual value Y for all of these and target saving Y/12 every month in the bank. All of these items will come from this account which is called a sinking fund

Savings:

- Any money above these two will go into your emergency fund. Target 6-12x over time into a bank account or liquid mutual fund for this purpose.
- Keep this bucket topped up for periods where income is lower than expected (the mandatory bucket is running low) or for unforeseen expenses
- Create another bucket called the fun fund: save money here for things that you want to do or have. Trips, gadgets, experiences come from here
- Emergency fund should not be used for "fun" or non-emergency expenses. Use the fun fund for that.

Investing:

- Anything after this, as and when you have the surplus, goes into investment for goals
- Given this is the lowest bucket, there will be a tendency to neglect this one. If there is a choice between contribution to the fun bucket vs this one, prioritize this first.

Jun 16, 2021

by @sayansircar

Should you maximize your PPF contribution of 1.5 lakhs?

Jun 17, 2021

Asset allocation must be appropriate as per goals. An investor needs a substantial amount invested in equity for long term goals like retirement to beat inflation. Fixed income products like PPF and EPF do not beat inflation.

If the salary is low, like at the beginning of the career, then the amount of money available to invest every month is not very large. New investors typically have a large amount of money in bank FD and employee provident fund. Given the lack of experience with equity markets, they are very concerned about the right time to enter the markets. At the same time, they are not comfortable investing a large lump sum amount in a few months.

In either of these two cases, diverting 150k (i.e. 12.5k/month) to PPF when you might already have Employee Provident Fund (EPF) leads to a too-conservative asset allocation. Having a low equity allocation will make it extremely difficult to achieve retirement goals.

The right time to invest in PPF is when your asset allocation allows investment in long term debt which will happen after a few years of investing in equity.

Someone starting in the first job should open a PPF account immediately. This way, the clock on the 15year lock-in can start. The investor can invest as low as 500/year to keep it active.

The investor should spend time setting the asset allocation as per each goal and start investing without delay.

by @sayansircar

How to "pay yourself first" to begin your investment journey?

Jun 18, 2021

by @sayansircar

Pay-yourself-first is a well-known concept that builds up a habit of saving and investing. This concept is similar to a loan where the lender deducts the EMI automatically every month. There are penalties for missing a payment. We can use the same technique for goal-based investing.

The main benefit of paying-yourself-first is that the money is moved **out of reach** before discretionary expenses start. It is like a salary that you are paying to your future self.

Based on how your income is structured, either regular from salary or irregular from your profession, business or freelancing, you should:

- Fix a minimum percentage value like 20%. The more you can allocate, the better it is for the plan to work.
- As soon as you get income, transfer that money to a separate investment account (automate this if there is a salary income). The process will fail if you do not follow this step.
- Whenever income goes up, bump up that percentage
- Maintain the percentage contribution as much as practical

Use this money to fill expense buckets in this order:

- **Bucket 0**: Monthly expense buffer to cover mandatory expenses for a few months to smoothen the budget. Salaried individuals can skip this step
- **Bucket 1**: Emergency fund: hold 6-12 months of expenses and all EMIs in 50:50 proportion in a savings account and liquid mutual fund
- **Bucket 2**: Sinking fund: This is for insurance payments, trips, festival shopping, white-goods replacement etc. Estimate the yearly value for all of these and target saving 1/12th every month in the bank
- **Bucket 3**: investment fund: invest as soon as this bucket has money as per your financial goals
- **Bucket 4**: Fun fund: save money here for things that you want to do or have. Trips, gadgets, experiences come from this fund

Should the same funds and folios be chosen for different goals?

Investors are often in a dilemma regarding the best way of structuring their portfolio for different goals. Some common questions while getting started with investing in multiple goals are:

- Should I be using different funds for different goals?
- If the same funds are used, should different folios be used to segregate among goals?
- If identical funds are used for different goals, should they be spread among different AMCs?

The answer to these is a mix of taxation, usability, behavioural aspects and AMC risk. We will deal with each of these separately:

- **Taxation during rebalancing**

The minimalist portfolio, by design, will minimise the number of transactions due to the netting effect across various goals. This leads to lower capital gains taxes to be paid. Segregated portfolios will have higher taxes

- **Usability and mental accounting**

Investors sometimes prefer some goals (like children's education) to be given higher priority which is easier to achieve via physical separation across funds or AMCs.

Alternatively, seeing the balances in different folios in a dashboard, with each folio tagged with different goals, may be easier to visualize progress.

- **Behavioural aspects**

Investors can be better off looking at a big picture view of their portfolios if they look at it frequently to minimize timing activities

- **Operational/market risks and AMC diversification**

AMC diversification is needed due to actions beyond the investor's control (e.g. March 2020 Franklin Templeton incident)

Jun 19, 2021

by @sayansircar

Which funds should you invest in?

Jun 20, 2021

by @sayansircar

We address the biggest problem that many investors are concerned with: which fund to invest in? **The solution is the 3-fund portfolio**.

The 3-fund portfolio is a very simple portfolio that uses diversified low-cost index funds to get as much exposure as possible to stock and bond markets. This concept has been popularized by the followers of Vanguard founder and investor advocate John Bogle.

The 3-fund portfolio may not necessarily have exactly 3 funds but the concept can be used by Indian investors quite easily to invest for their financial goals.

The simplest 3-fund portfolio has 2 asset classes and one fund in each equity and debt, in a proportion (asset allocation) as per the risk profile of the goal using DIRECT GROWTH mutual funds.

This is the simplest possible portfolio that can be chosen for any goal beyond 5 years until the end of retirement. For a goal closer than 5 years, the equity component should be zero depending on the risk profile. Typically for long term goals of 15 years or more, provident fund (EPF, PPF, VPF, Sukanya Samriddhi) can be used as long as there is enough holding in open-ended debt funds to allow rebalancing.

Why choose this portfolio and what returns to expect?

This portfolio is simple, has extremely low cost and is easy to maintain. The returns will very close to the overall stock market since only index funds are recommended in the equity section. It is very difficult to beat an index fund due to both cost and the human element that otherwise causes poor returns in the portfolio of active fund investors.

Such a portfolio, when rebalanced regularly with debt, will be both low maintenance and suitable for DIY investors who do not want the hassle of worrying about which fund to invest next.

RRTTLLU: check these when choosing assets for a goal

Jun 21, 2021

by @sayansircar

We cover 7 characteristics of assets that need to be considered when choosing what to invest in for a goal. These can be remembered using the mnemonic **RRTTLLU**:

- **Return (R):** Return expectation for a goal depends on goal characteristics like goal-priority (must-have, should-have, could-have), corpus target (how much money is needed), horizon, inflation applicable and investible surplus available to be allocated to the goal
- **Risk (R):** The risk profile of an investor depends on the least of the Risk-taking ability and Risk-taking willingness
- **Time horizon (T):** In general, the longer the time horizon of a goal, the higher can be the allocation to risky assets like stocks vs. safer ones since past data has shown that over long periods, there are more chances of getting inflation-beating returns with a higher allocation to risky assets recovering from short term falls in prices
- **Taxes (T):** Capital gains taxes can be complex depending on the asset chosen, the holding period, and the tax status of the investor at the time of exit
- **Legal / regulatory (L):** Legal and regulatory requirements generally vary from asset to asset E.g. PMS limits, income clubbing rules etc.
- **Liquidity (L):** Liquidity describes how easy it is to convert something into cash. For example, the order of liquid assets is generally: cash > FD > stocks / open-ended mutual funds > Sovereign Gold Bonds > Jewelry > Closed-ended MF > PF > NPS
- **Unique situations (U):** Unique situations vary from one investor to another. E.g. ESG investing, high grade-vs-high yield bond investing, restrictions against 'sin stocks' etc.

SIP vs. lump sum: what should you choose?

Jun 22, 2021

by @sayansircar

Lump-sum investments are easy to do if you know what you feel about it, not how markets move. A typical version of this question is which is better: SIP every month or wait for the market to “fall” and then invest a lumpsum. Since timing the market is very hard, investors should invest via a SIP in the same frequency as income.

This post deals with a different version of the same problem:

- if you have a large amount of money today (say a bonus, inheritance, real estate sale or gift), then how to invest it
- if you are starting investments and have a large amount in FD
- just exited a large holding in a fund or a stock
- want to switch a regular fund to direct

There is a behavioural issue here with the fears like if you invest

- **at one go**: what if the market falls immediately afterwards
- **break it into parts**: what if the market starts rising immediately

There is a lot of research that shows there is little impact of short term market movement on the long term performance of the portfolio, and timing the market is difficult to achieve for many people. Also, waiting for the right moment to invest is risky since markets may move suddenly leading to a lot of regrets.

So we make one simple plan to

1. minimize the regret of losses (loss aversion)
2. Reduce the number of active decisions to be made to ensure things are left to chance (and not blame themselves later)

- [ ] **Step 1**: Take the amount to be invested and divide it into “n” equal parts and invest each part every month

- [ ] **Step 2**: Make the number of investments to be chosen by chance: Throw a dice to find “n” - the number of investments you are making. Use a real dice or there are many online

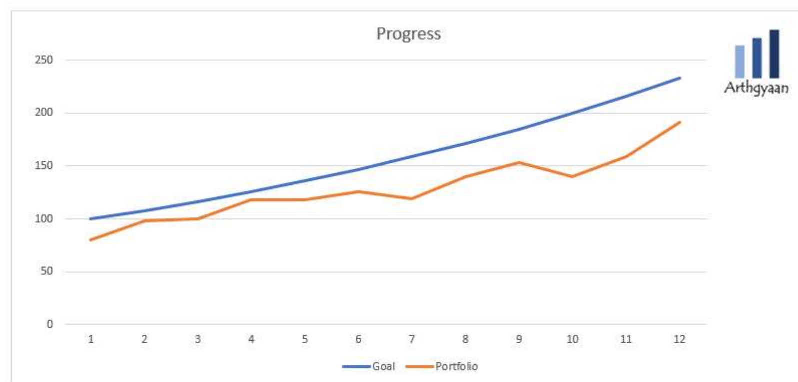
If you do not like the first result, you can always do a best of three.

Are your investments on track for your goals?

Jun 23, 2021

Goals like cars, houses, vacations, college education costs and retirement expenses etc. all increase over time due to inflation.

If the initial goal target was ₹ 10 lakhs today with 10% inflation, then in two years the goal value is expected to increase to around ₹12 lakhs. In reality, it could have become ₹ 12.5 lakhs or could have stayed close to ₹11 lakhs. In either case, a replanning is needed.



- Markets **do not go up in a straight line** like a fixed deposit. Both equity and debt funds go up/down unpredictably and in most cases give a return very different from the expected return. If the target return was 8% for the first year but due to bear markets only 5% return was achieved, it would require additional monthly investments going forward.

- The next process is rebalancing which is used for risk management to achieve one goal: **over time, the risk of the portfolio needs to reduce as the goal comes closer**. This is done via stepwise reduction of the equity exposure of the goal.

Rebalancing portfolio once every 6months or yearly

- allows systematically buying low, selling high
- should be done at the portfolio level (all goals together to minimize trades and taxes)

A replanning would require repeating the same process that was used to find the SIP amount: quantifying goal and risk profiling

by @sayansircar

Jun 24, 2021

What is a core-satellite portfolio and how to create it?

A core-satellite portfolio consists of a passive core of low cost, diversified index funds (70-100%) combined with an active satellite (0-30%) of concentrated and likely higher expense assets to generate higher risk-adjusted returns.

Depending on the risk profile, the following core to satellite proportion can be considered:

- low risk: 100% core, no satellite
- medium risk: 90% core, 10% satellite
- high risk: 70% core, 30% satellite

	Core	Satellite
Equity		
Domestic Index	✓	
International Index	✓	✓
Gold		✓
Direct equity		✓
Domestic mid/small caps		✓
Domestic Thematic		✓
Domestic Sector		✓
Domestic factor indices		✓
International Thematic		✓
Debt (domestic high grade)		
Low duration	✓	
Medium duration		✓
High duration		✓
Domestic High Yield		✓

What goes into the core?

The premise of the core is low-cost diversification. Domestic and international index funds and high grade (SOV/Cash) debt funds with duration < 1 year are in scope

What goes into the satellite?

The satellite portfolio balances a desire to get higher risk-adjusted returns at reasonable costs. Care must be taken to keep the total expense ratio of the satellite portfolio at reasonable levels relative to the expected returns.

A close watch on the correlations of these assets with each other as well as the main core portfolio needs to be kept. Rebalancing will have to be frequent to take advantage of opportunities and within tight corridors. This will lead to higher transaction costs compared to the core portfolio.

by @sayansircar

What should be the Asset Allocation for your goals?

Asset Allocation (AA), for a particular goal, strikes a balance between risky assets that appreciate fast (like equity) and slow-growing assets that provide stability (like debt). AA comes from risk profiling which is ability and willingness to take risk. For example:

- go for a foreign vacation in 5 years with a high risk profile - 7:93
- buy a house in 8 years with medium risk profile - 18:82
- save for children's college education in 12 years with low-risk profile - 30:70
- save for retirement in 20 years with medium risk profile - 60:40

AA will not be fixed throughout the life of the goal. This is the concept of the glide path which says that over time, the AA will change since the goal will come nearer with time and risk profile may also change (due to change in financial conditions or extreme market movements). There should be regular rebalancing to the new target weights at least once a year.

During the last few years of the goal, the corpus should be held in safe debt assets like bank FD or suitable debt mutual funds to ensure the goal can be met without taking unnecessary risks.

Tactical asset allocation

Tactical asset allocation (TAA) is a way of temporarily changing the AA of the portfolio to act on an opportunity as per market conditions.

For example, in an equity bull market, re-balancing from equity to debt as per trigger condition may be delayed to let the equity portion of the goal increase a bit more. TAA will change the risk profile of the portfolio in case the decision goes wrong and will require a more frequent review and re-balancing. There is no reason to do TAA for most investors. Ideally a strict rule-based approach should for followed for TAA under professional guidance.

Jun 25, 2021

by @sayansircar

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How does sequence of return risk affect your goals?

The concept of sequence-of-returns risk (SRR) refers to the order or mix of positive and negative returns that occur in risky assets like equity.

Managing SRR is important via glide-path and rebalancing yearly in order to reach goals. Only starting a SIP will not suffice.

SRR affects goals differently depending on whether they are accumulating (like saving for retirement) vs. whether they are in the distribution phase (like withdrawing in retirement). For example, the two sequences (-10%, 20%, 5%) and (-20%, 30%, 9%) lead to the same geometric average return of 14% but will impact a portfolio's final value depending on whether cash is flowing in or out.

- **SRR during investment for retirement**

In the accumulation phase, a few low periods of returns at the beginning of the period is better than having them at the end when the corpus is much bigger and fully exposed to market risk.

Also if the time left is very less and the asset allocation is very risky (say a 3-year goal mostly invested in equities) then there is a high chance of not being able to recover from an equity market fall before the goal is due.

- **SRR during withdrawing at the time of retirement**

When withdrawing from a corpus in retirement, a large fall or a period of sideways equity market at the beginning of the period will deplete the equity corpus fast. This may lead to the failure of making the corpus last till the end of retirement.

This problem can be tackled by having a higher allocation to safer assets like cash or high-quality debt to support withdrawal during the first few years using a concept like a bucket theory of asset allocation.

Jun 26, 2021

by
@sayansircar

How to plan for retirement using the bucket method?

Use the bucket theory of asset allocation to create a simple and stress-free retirement portfolio. This post simplifies the problem of portfolio construction for someone ready to enter retirement by creating three buckets of cash, bonds and equity.

Bucket 1: Cash (5% of corpus)

The purpose of this bucket will be to hold living expenses for the next 5 years along with one year of expenses as emergency fund in the bank or in liquid funds.

Bucket 2: Income assets (40-50% of corpus)

This bucket holds assets that generate income via

- interest payment (like government savings schemes like SCSS, PMVVY, Post Office MIS) or FD
- coupon paying instruments like RBI Bonds / AAA rated bonds
- payments from annuities

This income feeds down to Bucket 1. Additionally, the rest of the allocation to this bucket should be in open-ended debt mutual funds

Bucket 3: Growth assets (40-55% of corpus)

This bucket provides growth that beats inflation. This is very important given the interest rates in India have been falling in line with global trends. Going forward, as India becomes more developed as an economy, interest rates are expected to remain low and investing in equity remains the only way to beat inflation.

Rebalancing between various buckets

A yearly review must be done every year to move money between the three buckets as per asset allocation. Each rebalancing is handled first for each year in retirement and then summed up to get the aggregate change at the bucket level.

Jun 27, 2021

by @sayansircar

How to plan for retirement / FIRE using dividend income?

Jun 28, 2021

Stock dividends can be used to get regular income during retirement. For retirement, dividends are important in two ways.

1. Due to falling bond yields, there is limited income potential from bonds without taking credit risk
2. Rising inflation makes income from bonds not sustainable for getting inflation-indexed returns

Stock dividends are stable due to the value and quality factors inherent in high dividend yield stocks. The Nifty Dividend Opportunities 50 index, published by NSE, has shown a 2.8% yield since inception. The dividends of the underlying stocks have grown at a rate higher than inflation in this period.

While dividends can be cut in case of the company facing financial trouble, they do not fluctuate as much as stock prices in times of high volatility. This is important if, due to sequence of return risk at the beginning of retirement, there is a loss to the equity portfolio. Dividend stocks should be chosen based on quality and value factors and not solely by looking at the dividend yield. Avoid dividend yield thematic mutual funds due to high TER.

However, the dividend yield of a stock portfolio is typically lower than the safe withdrawal rate (SWR) used by retirees which means that additional income sources via income or capital gains is needed.

Taxation: Currently, dividends in India are taxable at slab rates. This means that as per the RRTTLLU suitability framework, dividend-paying stocks are unsuitable for the accumulation stage. In post-retirement, if taxes being lower, then dividends more tax-friendly than before.

Even at the highest slab rates, the possibility of stable income from dividends must be balanced against the lower taxation from stock and mutual fund capital gains.

Sources of finding high dividend yield stocks using index constituents:

- MSCI India High Dividend Yield Index
- NIFTY Dividend Opportunities 50 Index

by @sayansircar

Jun 29, 2021

Closet indexing: how to avoid funds that do this

Active mutual funds are expected to beat their benchmark indices as much as possible. For this, they charge higher fees (called Total Expense Ratio or TER) compared to index funds (which give returns comparable returns as the benchmark at much lower fees).

Closet indexing happens when an active fund's portfolio is very close to the underlying benchmark. This leads to two problems:

- only a small part of the portfolio is truly "active" which is unjustified given the TER difference with index funds
- going forward, it will become increasingly difficult for the active fund to continue beating the index

This is essentially a form of the agency problem. An investor is paying high fees in the belief that the fund manager is doing everything possible to beat the index, but in reality, the fees are being pocketed while keeping the portfolio very close to the index.

It is the phenomenon is prevalent in mutual fund categories where it is increasingly difficult to beat the index like large-cap funds.

How to find out if a fund is a closet indexer?

Calculate the active share using portfolio and index constituent data. Active share measures how "active" the fund portfolio is. This figure will be close to zero for index funds and a high figure for active funds. Closet indexers will be in the middle.

When choosing new active funds or reviewing existing active funds, investors should review the trend of active share and be wary if it is decreasing over time.

This indicates the fund is slowly becoming more and more index-like. This should be an important part of the mutual fund review process. Closet indexing is one of the reasons investors should consider investing in index funds for the majority of their holdings.

by
@sayansircar

Jun 30, 2021

When to Sell a Mutual Fund?

Mutual funds are to be sold when they have served their investment purpose i.e. used to fulfil a goal. Three common scenarios are:

1. When money is needed

Since the purpose of investment is spending money for a goal like buying a house, education or retirement, MFs need to be sold at the time when money is needed.

Cash is also needed in case of emergencies. If liquid mutual funds were used as an emergency fund then those MFs can be sold to get the money for emergencies. In case of long term emergencies like job loss or medical reasons, then even equity funds can be sold.

2. When rebalancing

Rebalancing as per asset allocation is done to manage the risk of the portfolio as the goal comes closer. This can be considered a form of "profit-booking" since rebalancing allows you to buy low / sell high.

MFs can be exited if the fund is no longer suitable for the goal (too much or too little risk, underperformance).

Selling a mutual fund by timing the market should be avoided since there is enough evidence that investors lose money doing this.

Mutual funds are also exited when their mandate changes (fund manager movement, portfolio strategy change, weights of debt/equity, ratio of large/mid/small caps etc.).

3. When exiting a fund due to performance issues

This is done when a fund review finds the fund to be unsuitable due to suitability or performance issues. Also if the investor has invested in regular or dividend funds then they should be sold to invest into Direct Growth funds.

by @sayansircar

What is the danger of starting investments late?

Jul 01, 2021

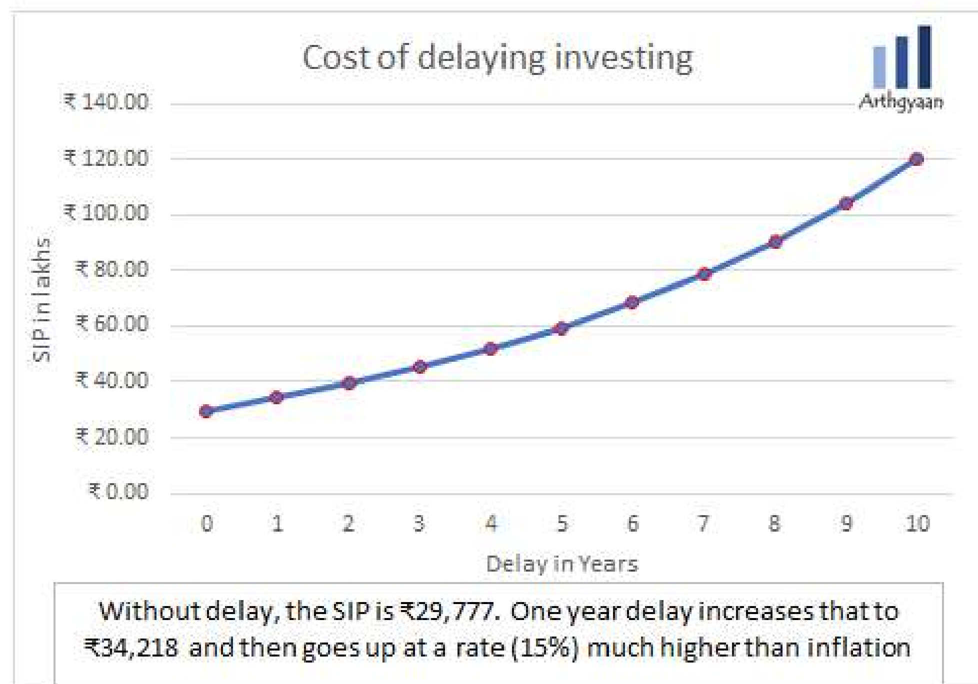
by @sayansircar

We will extend the concept developed while calculating for a traditional retirement goal and show what happens when investments are delayed. There may be many reasons for starting investments late:

- not calculating the cost of retirement goal
- not having an understanding of how to start investments
- always waiting for the right time to enter markets
- thinking planning for goals is complex

Impact of delaying on retirement goal

We will use an example where a SIP value of ₹ 29,777 is found for retirement 20 years away and ₹ 30 lakhs of starting lump sum amount. We will see what happens for each year of delaying investments for the next ten years. We assume that every year the starting expense of ₹ 6 lakhs increases at 7% inflation.



If there is one year of delay, the SIP requirement jumps by 15% to ₹ 34,218 and then to ₹ 39,300 (32% increase) if the delay is just 2 years. If the delay is 10 years, then the SIP amount jumps more than 4 times to ₹ 1.20 lakhs. This is the cost of starting late.

What is diversification: how and why should you do it?

Diversification is spreading risk across various investments so that all of them don't perform equally bad (or good) at the same time.

Diversification implements the saying "don't put all your eggs in the same basket" to investing. By diversifying, you allocate investments across various types of asset classes like stocks, bonds, gold, real estate across various countries and issuers (governments, corporations and others). By diversifying, you are reducing the risk that all investments do not start falling (and conversely rising) at the same time. Diversification reduces the risk of the portfolio and does not necessarily reduce returns.

Diversification comes from two concepts:

- source of risk
- investment in low or uncorrelated assets

Each type of investment (e.g. a company) has two sources of risk:

- unsystematic - a company's own performance and its perception
- systematic - inherent risk in the entire country's stock market

Diversification reduces unsystematic risk not just across various companies but across different asset classes as well until only systematic risk remains. For example, by adding more and more different types of assets, the risk decreases as in the table above.

Diversification can be done by choosing

- domestic equity funds
- domestic debt funds
- gold funds
- investments in real estate (residential / commercial)
- international mutual funds

While creating a diversified portfolio, care must be taken that

- cost of diversification does not become very high
- too many funds of the same type reduces diversification
- diversification may reduce the return of the portfolio while reducing risk

Jul 02, 2021

by @sayansircar

Why do you need to make an Investment Policy Statement?

Jul 03, 2021

by @sayansircar

What is IPS?

The Investment Policy Statement (IPS) is a written document that is the basis of goal-based investing. The IPS is the plan that helps getting started and allows decision making at every step of the journey.

It avoids ambiguity in decision making and deals with common situations that the investor faces. If the investor is engaging with a financial planner, then the IPS is the result of the engagement. For DIY investors, this post details how an IPS is made.

Why make an IPS?

IPS describes the why, how and what of investing. The document exists so that both the advisor and client (or alternatively the DIY investor today and their future self) can unambiguously define

- the purpose of the investment i.e. goals
- how the investments are to be made; in what assets / proportions
- how to deal with market movements, change in the financial condition of the client and change in goals

What is there in the IPS?

1. **Investor information**: income, dependents, career prospects, assets held, tax status and previous experience
2. **Goal setting**: horizon, cost today, inflation and priority as well as the prerequisites: emergency fund, term and health insurance
3. **Investment characteristics**: asset selection using RRTTLLU framework to define allowed and disallowed investments. This section will deal with questions like what investments are allowed (mutual funds, provident fund) and what is not (for example NPS, direct stocks and covered bonds)
4. **Asset allocation and security selection**: This section contains details on the asset allocation for each goal as well as chooses which funds and other assets to invest in
5. **Review and rebalancing plan:** This section contains the goal-wise glide-path and rebalancing plan in order to manage the risk of the portfolio

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Do you need a pension plan during retirement?

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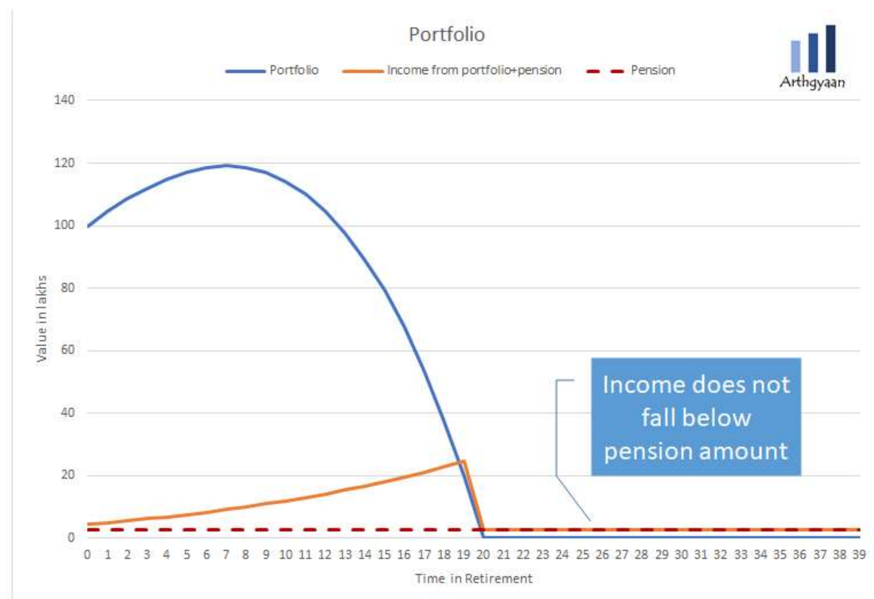
A pension plan is a financial product that gives you a fixed amount of money called a pension throughout your life. This allows you to have assured minimum income throughout your retirement.



A pension plan does not let your income fall below a limit. This is the trade-off vs. a goal-based retirement plan which fund a few more years in retirement but will then drop to zero. In either case you need equities in the portfolio to beat inflation during retirement.

When choosing a pension see if you need 50 or 100% payout for spouse, if you want your heir to get some money back and whether to start the pension immediately after retiring or defer it. Current pre-tax yields are around 5% after 18% GST on purchase price.

Three negatives of pension plans are

- Zero liquidity: cannot get money back if you decide to exit
- Poor returns post inflation (3% annual increment plans exist but even that is below inflation)
- The payouts are taxable at the marginal tax rate

You need a pension plan if the corpus is not large enough to last the amount of time you (and spouse) will be alive. There needs to be a balance between the amount locked into a pension plan and the rest that can give inflation-indexed returns.

by @sayansircar