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Financial Planning for Beginners- The Art of Asset Allocation

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Abstract

It's rightly said that "if you fail to plan, you are planning to fail". One can have numerous financial goals they wish to fulfill but these goals are only achievable at the right point of time only if they have a genuine financial plan from young age. Drawing up a financial plan can be a complicated task for the common man and most individuals take the assistance of professionals who can prepare and monitor their financial plans. Hence, it is very essential to have an appropriate financial plan in order to fulfill one's life goals without any hassle. A financial plan assists by providing direction and meaning to one's financial decisions. The present paper allows understanding how each financial decision affects other areas of finance.

Keywords: Financial Planning, Insurance Plan, Investment Plan, Retirement Planning, Tax and Estate Planning.

Introduction

The corona virus pandemic has strengthened one of the greatest lessons of investment. One cannot foretell the short- term returns of any asset class. For example, in the last calendar year we saw how the returns from equity first fell down during the first quarter and then an equally dramatic recovery thereon. In the same time period, some of the long duration bond funds generated two- digit return. Such volatility in returns may lead to a wrong decision by investors when it comes to entry and exit from their investment, which will ultimately expose to danger, the overall portfolio returns. Financial planning of investment may help to avoid such decisions.

Literature Review

As responded in a survey conducted by Ralph A. and Thomas S. (1991), some students were not interested in financial planning simply because they didn't have a complete or correct knowledge of the purpose of professional financial planning.

Rakesh H.M (2014), A Study On Individual Investors Behaviour In Stock Markets Of India, IJMSS (Vol.02, Issue-02), ISSN:2321-1784: The paper proposes to study the behavior of individual investors in the stock markets and the factors that influence their investment decisions, which include awareness level, investment duration etc

Reena Rai (2014), Factors Affecting Investors' Decision Making Behavior in the Stock Market: An Analytical Review, Indian Journal of Applied Research (Vol.4, Issue-9), ISSN - 2249-555X: The paper under study aims to study the factors influencing an investor's decision making behavior on basis of related studies. It states that the various factors that influence include various demographic factors such as gender, age, education. It is known that men are more overconfident than women.

Kaushal A. Bhatt (2013), Investment and Trading Pattern of Individuals Dealing in Stock Market, The SIJ Transactions on Industrial, Financial & Business Management (IFBM) (Vol.1, Issue-02), ISSN: 2321 – 242X: The paper aims at studying the literacy and awareness of capital markets among investors regarding various investment avenues. To find and identify segments preferred more by the people and the influencing force behind the decision making, while investing in currently available options including stock markets. It concludes that investors are moving to new investment avenues such as equity market, mutual funds, bonds, and others like gold, land etc.

Nachiket Bhate and Alok Bansal, Personal Financial Planning: A Review, Altius Shodh Journal of Management & Commerce, ISSN 2348 - 8891: states that personal investing helps to achieve major emergency funds, buying a real estate later on and better cash management, personal finance and investment alternatives and retirement plans. One needs to appoint a better fund manager to ensure stability while managing risk. People don't consider Insurance and other secured schemes as asset. Hence they end up investing into such products with are not able to beat the inflation. It was concluded that disciplined way of investing and diversification of funds including Insurance products boost their personal financial planning.

Gurinder Singh And Navleen Kaur (2015), Investigation of the Determinants to Augment Investment in the Indian Stock Market, International Journal of Scientific and Research Publications (Vol.5, Issue-03), ISSN 2250-3153: states about the perception of investors and non-investors towards Indian Stock Market. Those who are non-investors always calculate the insecurity of loss of money in the market and the risk of investing. There are other categories of people who are ready to invest but they want investor friendly schemes, which are not only simplified but also have an easy exit option. So government and fund houses need to spread awareness about investor on a large scale.

Kajal Gandhi (2015), Retail Investors Participation in Indian Stock Market- A Survey, GJRA - Global Journal For Research Analysis (Vol.4, Issue-02), ISSN No 2277 - 8160: paper findings were based on the survey which has been carried out among five cities-Mumbai, Delhi, Kolkata, Chennai and Ahmedabad. The respondents of the metro cities are more inclined towards investing in stock market as they consider it as financial tool but they don't have expertise knowledge or don't prefer to hire a professional to manage their portfolio due to which they fall prey of losses. However, people at Tier-II cities like Ahmedabad still consider the traditional investment like gold, property, gold and bank deposits are their favourite option this is due to narrow minded as there is low saving habits, low awareness of investment opportunities.

Financial literacy plays important role in managing the earned money of an individual. It is a difficult task in itself and managing the finances for others, the challenges get exponentially high. Considering the difficulties that people face and the guidance they require on where to invest and how to grow their funds in the market paves way for the personal financial planning profession. The profession involves providing guidance to the people on investment, mortgage, insurance, college savings, property taxes, and retirement (BLS, 2017). The need for personal financial consultations is high in India as the country is going through a rapid expansion in terms of existing financial services firms as well as there is the addition of new and diverse financial products coming into the market (G.Srinivas Rao, 2018).

Theoretical and Conceptual Frameworks

Financial planning is an activity of meeting one's life goals by way of proper management of his/her finances. An individual has several short- term as well as long- term goals. A financial plan acts as a guide as one goes through life's journey. By scanning each financial decision as part of a financial plan, it may help an investor to review the long- term and short- term effects on his/her life goals. This will help investor feel more secure and more adaptable to life changes once they can measure that they are moving closer to the realization of their goals. A financial plan chiefly consists of five categories such as insurance planning, investment planning, retirement planning, tax and estate planning and asset allocation planning.

Financial plan must have reasonable insurance in order to insure oneself and family against any unfortunate episode materializes in the future. An investment plan helps to achieve

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long- term as well as short- term life goals and assists in saving at regular intervals. A retirement plan will support during sunset years to be stress- free. A tax plan assist an investor in earning tax- efficient income while estate planning is the exercise by which an individual or family arranges the transfer of assets in anticipation of death or incapacitation.

Insurance Plan

Forces that endanger our financial prosperity continually surround us and are in general outside our direct control. Some persons encounter the premature death of their near and dear ones or loss and demolition of their property from both manmade and natural calamity. Hence, it is immensely important to safeguard our financial wellbeing by insuring against any occurrence of an unfortunate event. Insurance is shifting the risk from a single to a company and shrinking the unpredictability of risk via pooling. As life changes, the insurance requirement also change. Therefore, insurance planning is not a one- time process; it requires regular monitoring and assessing in order to sufficient cover of ones risks against any uncertainty. Following are the ingredients one need to examine while starting insurance planning:

- Age (whether young, middle- aged or retiree)
- Family status (single, married, divorce, with children, without children)
- Health and accordingly family's health
- Assets (car, house or any other property either mortgaged or not) and,
- Professional status (i.e. student, employed, unemployed or self- employed)

All above factors must be considered for sufficient insurance because under- insurance as well as over- insurance can be risky. Under- insurance may lead to great financial stress in case of unfortunate events. On the other side, over- insurance open to excessive monthly premiums, this may hamper his/her current finances. One should possess the following basic insurances:

✓ **Life Insurance:** This will cushion the insured's family in case of any financial crisis at odds with unexpected death of the insured.
✓ **Health Insurance:** Here the insurance company helps the insured as well as family members by meeting medical expenses.
✓ **Personal Accident Insurance:** This protects the insured financially against any unlucky situations emerging due to an accident. This category of insurance envelops an individual against death or partial or permanent dysfunction due to an accident.
✓ **Property Insurance:** An individual might possess several properties that may face uncertainty and cause loss. Hence, in order to secure own self against any financial crises one should possess adequate property insurance.

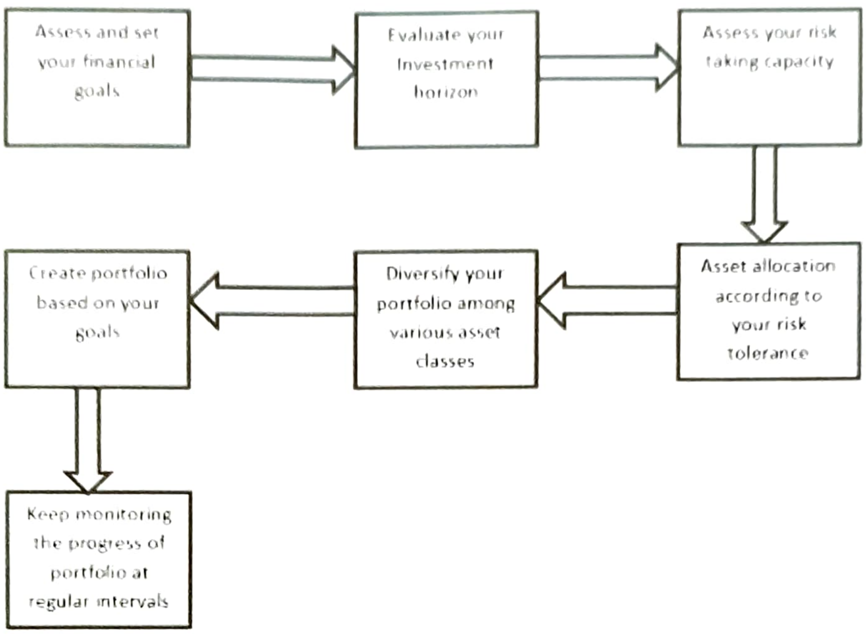
Investment Plan

Smart investment is extremely needed in order to make financial survival better, it assist in providing adequate funds to make dreams come true. Customarily, Indian investors find fixed income instruments because they supply safe and assured yields. Investments ought to be able to generate higher returns on investment portfolio that may help to come closer to one's financial goals. An acceptable and genuine investment plan is needed to build higher capital with higher returns for finer stability over an extended period of time. Following are few fundamental rules of investment.

- Start early,
- Invest regularly, and
- Ensure higher returns on investments

Investment planning is the procedure of recognizing financial goals and redeeming them at required intervals. ***"The core aspect of financial planning is investment planning."***

Basic steps while drawing an investment plan:



It is hard to advocate specific portfolio as one size does not fit all. As mentioned in the above diagram, every individual shall have separate individual goals, timeframes, risk tolerances and personal financial situations. However, for better understanding we try to generalize it and design an asset allocation plan based on financial goals. First of all varied financial goals should primarily be recognized based on the timeframe. Which may be?

- Near- term goals (less than three years)
- Short- term goals (between 3 to 5 years)
- Medium- term goals (between 5 to 10 years)
- Long- term goals (between 10 to 15 years)
- Very long- term goals (more than 15 years away)

Once financial goals are ranked according to different time periods, the next step is to split them into needs and wants. There are some goals that cannot be kept away, such as, retirement, child's education, medical care, while there may be few financial goals that can be postponed, such as, international vacation or upgrading mobile phone every year. The given below table is a rough guide for asset allotment based on one's financial goals and its seriousness.

Goal Time Horizon	Needs		Wants	
	Equity	Debt	Equity	Debt
Near- term goals (less than three years)	0.00%	100.00%	0.00%	100.00%
Short- term goals (between 3 to 5 years)	0.00%	100.00%	20- 30%	70- 80%
Medium- term goals (between 5 to 10 years)	40- 50%	50- 60%	50- 60%	40- 50%
Long- term goals (between 10 to 15 years)	60- 70%	30- 40%	80- 90%	10- 20%
Very long- term goals (more than 15 years)	70- 80%	20- 30%	90- 100%	0- 10%

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Individual should also acknowledge that as and when goals move towards their horizon, asset allotment is required to be changed accordingly. For example, when an individual is 30 years old and saving for his/her retirement, an individual may invest up to 80% in equity. As an individual become elderly and reach the age of 55, asset allocation should now match with short- term goals and 100% of his/her asset should go towards debt. Other than the broader asset class of equity and debt there are sub- asset classes. For example, within equity there are large- cap, mid- cap and small- cap. For a prudent (conservative) investor, equity allotment shall be towards large- cap. A moderate investor may invest in mid- cap and small-cap funds only if goal is beyond 10 years.

Asset allotment can also be linked to the stage of an investor's life. The life cycle of an individual can be sub- divided into young investor, young couple in mid- 30s, mature couple with grown up children and retired couple. But still, what remains customary in all approaches is that short- term goals should have more allotment towards debt and long- term goals need more allotment towards equities.

Retirement Planning

Retirement planning is exceptionally important because the standard of life for a massive part of the later years depends on the type of retirement planning undertaken. The present area of planning justifies a closer look, and hence everyone should be focusing towards effective ways to plan well in order to enjoy life after the hard work put during the best years of one's life. Retirement planning is the exercise of projecting financial planning to provide for the period after one retires from work. In other words, it is the process of saving and building up a corpus that is invested in different asset classes that should result in income and earnings for the individual over a period of time.

Key features in terms of actual steps in retirement planning

Understanding the above steps with help of the following example:

How to calculate retirement goals? Let us assume, Mr. Sachin Mathur is a 35- year old husband and is presently employed in an MNC in the position of sales manager with a salary of Rs. 2.5 lakhs per annum. He has one son who is eight years old and his spouse (home- maker) is also 35 years old. His current household expenses are Rs. 1 lakh per annum. He is planning his retirement at the age of 60. The life expectancy of both Mr. Sachin and his spouse is 75 years. Hence, what amount of corpus shall be required if they need to sustain the same quality of life post- retirement. A pension plan provides 8 per cent per annum and inflation rate is 5 per cent per annum.

Current annual household expenses = Rs 1 lakh

Post- retirement household expenses = Rs 1 lakh

Inflation rate = 5 per cent per annum and number of years left for retirement = 25 years

Estimated post- retirement expenses = Rs 3,38,636 (Amount x CVF (r%, t) i.e.,1,00,000 x 3.38636) and pension plan offers 8 per cent per annum.

Real rate of return (inflation- adjusted rate) = 2.86 per cent i.e., $\frac{1 + \text{nominal rate}}{1 + \text{inflation rate}} - 1$

Post- retirement years = 25 years (75 years – 60 years)

Mr. Sachin should receive Rs 3,38,636 as pension every year after retirement in order to survive his post- retirement life with same standard of living.

Purely from a financial planning view, Sachin should also invest in another pension plan as well in order to survive stress- free and happy retirement years without depending on his children.

Tax and Estate Planning

Tax planning is the task of scrutinize a financial plan or circumstances from the tax perspective. The primary motive of tax planning is to be assured that there is tax efficiency. One can generate wealth efficiently by investing in investment vehicles that offer tax benefits. Tax planning requires applying numerous advantageous provisions which are legal and entitles the assesse to enjoy the benefits of deductions, concessions, rebates and exemptions. A method that minimizes how much one pay in taxes is referred to as being tax- efficient. Tax planning must be an indispensible part of an individual investor's financial plan.

Estate planning is the process through which an individual or family fixes the transfer of assets in prediction of death or incapacitation. An estate plan aims to safeguard the maximum amount of wealth possible for the intended beneficiaries and flexibility for the individual before death. Wills and trusts are familiar ways through which individuals dispose of their wealth. Few other tools are power of attorney, gifts, etc., when the will is not made. Many people are of the school of thought that estate planning is displeasing subject. They put it off because they think they do not own enough assets to plan or they don't like to think about death. Unfortunately, ignoring these issues at present may cost your family thousands of rupees later, as well as lead to considerable anguish. Intelligent estate planning can give tremendous peace of mind.

Conclusion

One should hold an appropriate financial plan which must comprise adequate retirement planning. An individual need to have a blend of various investment vehicles which should provide stability, regular income and emergency and medical assistance without depending on anyone. Investing in a pension plan will help an individual in receiving tax efficient regular income post- retirement with the coverage of insurance.

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