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PENNY WISE

DO NOT FOCUS ON MAXIMISING RETURNS; JUST OPTIMISE THEM

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Three neighbours, Mr Shah, Mr Mehra and Mr Iyer, went down the elevator at 09:15 am together. Shah wanted to go to the bank at the end of the street and decided to walk. There was always a problem finding parking near the bank, so it was sensible to walk.

Mehra had an important business meeting at 10:30 am in a nearby town, about 40 kilometres away. Keeping in mind traffic and road conditions in the city, he calculated that after reaching the highway, even if he drove at an average speed of 50 kmph, he would reach well in time. Though the fastest possible speed at which his car could move was 180 kmph.

Iyer was running late for his flight. Reporting time at the airport was 09:30 am and the airport was at least 40 minutes away. He told his driver to drive as fast as he could.

In each of the three instances, the people chose the mode and speed of transport based on their need. Shah had a car but walking was a better option. Similarly, Mehra's car could travel at 180 kmph but there was no need to take undue risk. For Iyer, there was no choice but to rush at the maximum possible speed.

In developing our investment strategy, we should apply the same philosophy. Develop a plan that is aligned to your financial goals and do not simply try and maximise returns. Maximising returns, at times, can create undue risk.

Suppose Shah were to take the car to the bank. He would reach the bank quickly but he would waste time searching for parking. Similarly, if Mehra drove at 180 kmph, he would reach very early but there is risk of an accident. If Iyer decided to walk to the airport, he would certainly miss his flight. If there is a mismatch between your financial goals and investment strategy, you may either not reach your financial goals at all or may not reach at an appropriate time.

Suppose you need Rs 1 lakh to renovate your house after a year. If you have already accumulated Rs 96,000, you only need an additional 4% return in the next year, which can be generated by most debt instruments. There is no need to invest in the equity market and take additional risk. Similarly, if you need to generate 15% annualised returns to accumulate corpus for your daughter's higher education after 10 years, choose equity as an asset class. By parking your funds in a bank fixed deposit, you will not reach your destination.

In most cases, people do not exactly know what they are saving for. While this may sound absurd, find out how many families around you (including your own) actually do have a written list of financial goals—along with the amount needed and when—for which they are saving money. If you do not know your financial goals, you will try and copy others to maximise your returns and in most cases end up taking unnecessary incremental risk.

(The author is a certified financial planner)