Financial planning for a volatile 2014

With the Sensex returning 15% over the past year, it may make sense to play it safe till things are clearer on a number of fronts

Usually, financial planners advise one to rejig portfolios at the start of the financial year for two reasons. One, to build financial discipline. That is, if you are declaring investments or insurance premiums to save on tax, starting in April ensures the financial burden is distributed over the next 12 months. Two, with the Union Budget usually in February, investors are aware of the additional tax benefits/burden for the financial year and can plan, accordingly.

In that respect, 2014 is different (it happens every five years) due to the Lok Sabha elections. With elections results on May 16 and the Railway and Union Budgets after that, it is unclear how the stock markets will move. For instance, in 2004, when A B Bhardhan of the Communist Party of India (CPI) said "disinvestment *jaaye bhaad mein* (may go to hell)", the Sensex fell 800 points in a single day. In 2009, the Sensex hit the upper circuit within the first hour, when the United Progressive Alliance (UPA) came to power without the Left.

No wonder, both stock market players and investors are on tenterhooks about May 16 results. Last week, Bank of America Merrill Lynch predicted if there was a stable (Bharatiya Janata Party-led) coalition, the stock markets could rise another 10 per cent by the end of the year.

Given the uncertainty, the advice from investment and financial experts is to wait for clarity on both elections and Budget fronts. If the uncertainty is prolonged, investors may have to play it safe.

Defence, as a result, could be the best form of offence now. So, how do you do it? Manoj Nagpal, chief executive officer (CEO) of wealth management firm Outlook Asia Capital, says rejigging of his clients' portfolio happens on three occasions - when the client sets a numerical target of rebalancing the portfolio, such as making 20 per cent gain on it; when the target corpus or lifestyle goals are met, like purchasing a car or a house; and, when there are unforeseen events, global, local or personal.

Though the gains over the past year at 15 per cent aren't exemplary, if you follow an asset allocation model, there could be a case for moving profits from one asset to another if returns have been better. Some large-cap funds returned as much as 25-28 per cent. Then, there are select mid and small-cap funds that have given over 30 per cent returns in the

past year. Pankaj Mathpal, financial planner, suggests booking profits from such funds. For instance, Reliance Small Cap Fund (44 per cent), Birla Sun Life Pure Value Fund (42 per cent), Franklin India Smaller Companies Fund (40 per cent), UTI Mid Cap Fund (39 per cent), SBI Magnum Midcap Fund (37 per cent), DSP BlackRock Micro Cap Fund (36.50 per cent) and so on. Move the profits from such funds to debt.

However, remember that exiting funds where you invested less than a year before attracts an exit load of one to three per cent and a short-term capital gains of 15 per cent.

So, where does one invest the gains? Says Pankaj Maalde, head - financial planning at Apnapaisa.com: "Don't invest in bank or postal fixed deposits, especially if you fall in the high income bracket, as tax will eat into your interest income. You can invest in debt funds."

To decide better, see how much time you have in hand. Invest profits in debt if you have less than three years in hand, as you are near to your goal and can't take any risk with the corpus. Invest in ultra short-term funds (one-year returns = nine per cent) if you have up to six months of horizon. Opt for fixed maturity plans (FMPs; one year returns = 8-10 per cent) if you have up to or a little more than one year in hand. And, invest in income funds (one year returns = 4.70 per cent) if you have two to three years in hand. If you have an investment horizon of more than three years, you should invest in equities as you can take high risks.

However, if you have a goal coming up in the near future, like if you plan an international holiday next year, you can pick up a fixed deposit (State Bank of India is offering nine per cent for deposits maturing in one year to less than two years) or an FMP. Or, if you plan to buy a car in three years from now, you can invest in a three-year FMP.

Those three to five years away from retirement should move their money to a combination of fixed deposits and debt funds. Safety of capital is of utmost importance to such individuals, as they might not have an income after retirement.

Tax-free bonds are another product one can invest in, especially those in the highest tax bracket. However, avoid bonds that come with a call option. If interest rates fall significantly, the bond issuer can exercise it and pay the capital plus interest and take the bond back. In the absence of fresh issues, these bonds can offer attractive returns. In fact, these would offer huge capital appreciation to investors once interest rates start falling. That is why financial advisors are asking individuals to try the secondary market to stock on tax-free bonds.

But these investors can get into a tricky situation if they have to exit prematurely in an emergency. This is because FMPs and tax-free bonds, though listed on the stock exchange, are extremely illiquid and rarely traded on exchanges. One is often forced to sell at a huge discount.

Also, consider your profile as an investor. Nagpal feels if one moves the profits from equities to debt right now, it will only provide psychological and emotional comfort of having protected the profits you made after a long wait. He proves that with numbers. Say you had invested Rs 70 in equities a year before and Rs 30 in debt. Today, the equity portfolio would be standing at Rs 80.5 and debt at Rs 32.4. Thus, your portfolio is worth Rs 112.9 today. When you rebalance you would want to go back to the 70-30 ratio, which here would be Rs 79.03 in equity and Rs 33.87 in debt. To rebalance, you will need to move out Rs 1.47 to debt.

Let's assume the markets will fall 15 per cent after the elections, if there is no clear majority. In that case, your equity portfolio will go down to Rs 67.17 and debt will remain at Rs 33.87. Total = Rs 101.04.

If you had not decided to move profits to debt, your equity portfolio would fall to Rs 68.43 from Rs 80.5 if the markets fell 15 per cent after elections. Debt would remain at Rs 32.4. Here, the portfolio would be worth Rs 100.83.

In other words, in some cases a rejig might not make great sense. You could stick to Nagpal's advice, if you are young because you can take more risk and so equities is the best instrument for you. You could also follow his advice if your goals are more than three years away.

In times like these, you can always deviate from the original investment plan. But a marginal, rather than massive deviation, is preferred by financial planners because right now, equities are doing very well.

DEBT FUNDS DEMYSTIFIED

Debt-oriented hybrid funds: These funds offer a combination of equity and debt instruments and, hence, are supposed to be a good hedging tool against market volatility. Typically, equity and debt have an inverse relationship. So, you stand to gain even if one component is underperforming. Hybrid funds invest up to 65 per cent of the corpus in debt and the rest in equity. It is taxed as a debt fund, where the short-term capital gains are added to the income taxed as per slab and long-term gains are taxed at 10 per cent without indexation and 20 per cent with it

Ultra short-term funds: They invest in debt and money market instruments, with a maturity ranging from 90 days to one year. Though riskier than liquid funds, investors get better and more tax-efficient returns

Short-term bond funds: They invest in debt and money market instruments for one to two years

Medium-term debt funds: They invest in bonds, debentures, govt securities and money market instruments. They are more volatile in nature, as their portfolios have instruments with longer maturity duration. But returns can be better

Gilt funds: They primarily invest in government securities, issued as a part of the government's borrowing programme. Suited for those seeking safety and liquidity, the downside is that their prices fluctuate sharply, due to higher sensitivity to interest rate movements

Arbitrage funds: These aim to take advantage of the arbitrage opportunities between the cash and derivatives markets. They buy in the cash market and sell futures at the same time. These are also called 'market-neutral funds'. These are taxed as equity, where the short-term capital gains are taxed at flat 15 per cent and long-term gains are tax exempt

(Business Standard)