Fundamentals of Investing

Invesco Mutual Fund

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Need to save

1. Why do we save?

Savings form an important part of every individual's life and enables us to be self reliant, meet contingency needs/goals during our lifetime and be financially secure post retirement.

The money we save is set aside as a reserve, instead of spending it immediately. This is done with a purpose to accumulate a fund over a period of time, so as to meet the expenditure like children education, purchase a car, house, leisure etc. in the future, or to use it in case of an emergency.

The time duration taken to achieve these goals depends on how much amount of money we can put aside as savings every year. In simple words, the more we save and the earlier we start, the better off we are. This is due to the cumulative effect of money begetting money over an investment time frame, which in financial parlance is known as 'Power of Compounding'.

2. How does saving money help?

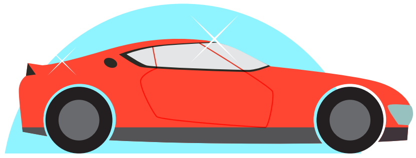
Now we have understood the importance of saving, let us see how regular savings can help our money grow. Consider an example, the most common practice of keeping money with a bank, which earn interest at the prevailing rate:

Goal

To purchase a Car

Current Cost

Rs. 5 Lakh



Yearly Savings	Assumed Rate of Interest	Years taken to achieve the goal
Rs. 50,000	8% p.a.	> 7 years*

*Based on simple interest at the end of each year.

Thus, we see that investing money makes good sense, as it can aid us in achieving our financial goals much faster. Not investing at all could be a costly proposition as we may miss the opportunity of growing money.

3. Have you realized what can possibly go wrong with the savings?

There is a possibility that the cost of the car, which is proposed to be purchased, can go up in the next ten years. Today it may cost Rs. 5 lakh, but next year it may be priced at Rs 5.25 or Rs 5.50 lakh depending on the cost of the production and other factors. This increase in level of prices is corresponding to an economic phenomenon called **'Inflation'** (i.e. trend of rise in general level of prices of goods and services over time). In such a scenario, if money accumulated by saving does not keep pace with the inflation, the increased cost of the car can delay the purchase decision or may put it off completely.

4. What is the solution?

We have observed that there is threat of rise in prices of goods and services over time, known as **'Inflation'**, which can derail our financial plans. Therefore, we need to find alternate investment avenues which are capable of combating these inflationary trends. To put it in simple words, we need to invest our savings so that our investments grow at a rate that can beat the prevailing inflation rate.

5. How is 'Investment' different from 'Saving'?

An investment requires us to identify our goals and invest in a variety of assets such as stocks, bonds, mutual funds, real estate etc. that matches with the risk profile. It's a scientific process whereby an investor has to consciously develop an investment plan and review it regularly in line with his changing needs. Savings, however, generally refers to money put aside, normally on a regular basis such as bank deposits.

The distinction between savings and investment is important, as savings typically do not exhibit investment risk (causing capital loss); unlike investments which are market linked and can therefore display fluctuation in value. Further, investments generally entail longer time horizon and are linked to various life goals such as buying house, marriage, child's education, retirement etc. Savings, however, entail shorter time horizon with money being parked in safe and liquid assets, which can be accessed easily.

By having an investment plan in place and buying assets which have the potential to grow in value and beat inflation, can help protect our financial savings from inflation and realize our financial goals in time.

2 Importance of investing

1. Why one needs to have an investment plan?

The basic premise for starting a detailed investment process is to allow our money to grow, as opposed to it lying idle with us or not delivering adequate returns. This is because the real value of the money in future may not be equal to the value at present, due to inflation as discussed earlier.

With the increasing consumerism trends, our aspirations are also rising. Therefore, investments aimed at just beating inflation will not help us achieve our aspirations. Thus, other long-term reasons for starting an investment process could also be to realize our aspirations.

The followings 3 steps must be followed to build an investment plan:

- Identification of goals and the time duration required to achieve them.
- Identification of suitable investment avenue to suit our needs.
- Make regular investments and review it periodically.

2. So, when should one start?

There is no ideal age or time to start investing. The earlier we begin investing, the better for us. A difference of few years can make a lot of difference due to a mathematical phenomenon called 'Compounding', whereby we start earning not only on our principal but also on the accrued earnings.

Einstein referred to it as the "eighth wonder of the world", and it can seem almost like magic. The money multiplier effect can make a substantial difference to our savings basket, if we start early and leaves the invested amount untouched for a longer period.

Let us see both the scenarios by way of an illustration:

Illustration: Money begets Money

If Mr. A, who starts investing at the age of 35, invests Rs. 1 Lac per annum, then at the age of 60 he would have a retirement kitty of approx Rs. 92 lakhs, assuming a growth rate of 9%. But, let us assume that there is Mr. B, who started investing at the age of 25. Assuming the same growth rate, the retirement kitty would have swelled to approx Rs 2.35 crores. The difference in the retirement kitty is amazing and illustrates the power of compounding. The gap gets wider if the growth rate is higher during the investment period. The following table will give us some idea:

(Rs. In Crores)

Growth Rate* (p.a.)	Retirement Kitty of Mr. A (started investing at age of 25)	Retirement Kitty of Mr. B (started investing at age of 35)	Difference in retirement baket*
6%	1.18	0.58	0.60
9%	2.35	0.92	1.43
15%	10.13	2.45	7.69

* The earnings rate in the above illustration are hypothetical and does not in any manner indicate the prevailing rate of return. Assuming the person retires at age 60.

There are two key things to be observed from the above illustration. Firstly, the age at which a person starts investing can make a lot of difference. A mere headstart of 5 – 10 years can make a lot of difference in the long run. In fact, the money multiplier effect ensures that the money grows at a very rapid pace in the later years, as an investor starts earning on not only his principal amount but also on his accrued earnings. Secondly, the rate at which our money is growing also makes a significant difference in the end. A difference in the growth rate can make a lot of difference, as can be observed from the illustration. A conservative rate of interest of 6% p.a. which can be achieved through fixed income securities and an aggressive growth rate of 15% which can be achieved through equity investments can make a difference of approx Rs. 8.95 crores at the time of retirement, if a person starts investing at the age of 25.

Therefore, it is not only imperative to start investing at an early age, but also necessary to select the right instrument which can generate higher growth rate during the investment tenure, keeping in mind our needs and risk appetite.

3

Understanding risk appetite

Assess your risk-profile

Once we have defined financial objectives and the investment duration, it is time to make the investment decisions based on the risk appetite. It is interesting to note that social personality traits of a person can be different from the way he behaves when it comes to taking financial decisions. For example, a person may be very aggressive in his social life, but may be very conservative in the way he manages his money. The amount of risk a person can undertake depends on a lot of factors including his age, liabilities, number of dependants etc. For example, the ability to undertake risk is more for a young executive who has just started working and has limited liabilities. In contrast, a middle aged executive in his 40s with number of dependants will be more averse to risk-taking. The risk appetite of a retired couple would be the least, as they don't have a source of income, and for them preservation of their capital is paramount. Therefore, depending on the risk appetite, proportionate allocation to different asset classes can be decided based upon the one's risk appetite and needs, ranging from risky assets to relatively safer investment products.

4

Types of risk profiles

Broadly, there can be 3 types of risk profiles:

Conservative Investor

Those who have low risk tolerance and are often uncomfortable with market volatility. For such investors, preservation of capital and current income are more important than growth of capital. Conservative investors choose investment products that do not fluctuate much in value.

Moderate Investor

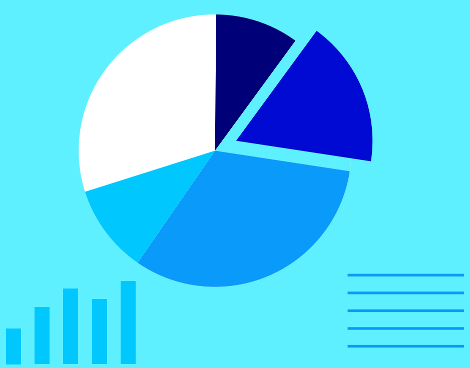
These investors can tolerate more risk than a conservative investor for more reasonable returns. For such investors, primary investment goal is capital growth and can tolerate some fluctuations in the value of their investment in anticipation of possible higher returns.

Aggressive Investor

For such investors, primary investment goal is long-term capital growth. These investors can tolerate significant fluctuations in the value of their investment in the short-term in anticipation of the highest possible long term returns.

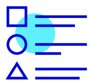
5

Asset classes



Once we identify our risk profile, we need to decide the appropriate asset classes in tandem with our risk appetite.

We may choose the following asset classes for investments:-



1. Types of asset classes

The different types of major asset classes available to Indian investors are as follows:

Depending upon the risk profile, an investor can choose to invest in any of the above mentioned asset class - where each one has a unique risk-return tradeoff - or a combination of some or all of the asset class, to build a portfolio.

Cash

Cash and cash equivalent refers to liquid and current assets comprising of hard currency and near currency assets viz. T-Bills, commercial paper, certificate of deposits, short-term government bonds, which can be converted to hard currency immediately or on a very short notice. It is an important asset class, and is also used as an effective asset allocation tool by the portfolio managers.

Stocks

Stocks refer to the shares of a company, which is a unit of ownership in the company. As you acquire more stock, your ownership stake in the company increases. Whether you say shares, equity or stock, it all means the same thing.

Holding a company's stock means that you are one of the many co-owners (shareholders) of a company and, as such, you have a claim (proportionate to your holdings) to everything the company owns. This means that technically you own a tiny sliver of every piece of furniture, every trademark, and every contract of the company. As an owner, you are entitled to your share of the company's earnings as well as any voting rights attached to the stock.

Stocks are generally more risky and there is no guarantee of any steady income. Investors can gain by appreciation in their capital value over a period of time, but should also be ready to assume the risk of losing a part or whole of the investment.

Bonds

A Bond is a debt security, in which the issuer owes the holder of the security a debt, and is obliged to repay the loan amount along with an interest upon maturity of the loan period. In India, the debt market mainly consists of Government Securities and Corporate Bonds. The issuers comprise of three different categories- government owned financial institutions (FIs), government owned public sector undertakings (PSUs) and private corporates. The FIs, PSUs and Private corporates which do not have access to retail deposits like banks, depend on bond issues for raising funds. The different types of bonds in the market are fixed rate bonds, floating rate notes, zero coupon bonds, asset backed securities, mortgage backed securities etc.

Gold

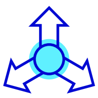
Gold as an investment has held appeal to Indians for centuries. Gold is considered to be an effective hedge against inflation. The yellow metal also provides for a store of value, and has limited downside risk.

Real Estate

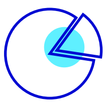
In the last few years, the Indian real estate sector has drawn a lot of interest from consumers and investors. Overall, housing demand in India has been on the rise. Real estate as an asset class is not readily accessible for the retail investor, because of the high entry barrier, large capital investment and lack of transparency.

6 Tenets of financial planning

Financial planning is unique to each investor based on his individual preferences and needs. However, there are some time-tested tenets which every investor should follow, to protect the downside risk in his portfolio.



Diversification is the first thing that any individual investor should look to build into his portfolio of investments, to minimize the risk associated. Different asset classes do not behave in exactly the same manner over a period of time. For example, the way equity markets behave and perform may not be completely correlated to the returns provided by gold. Therefore, the age old advice of not putting all the eggs in one basket holds true in the investment world as well.



Asset allocation is another important tool which can help an investor immensely. It basically refers to how an investor spreads his investments across various asset classes. This is determined solely by assessing the risk appetite of the investor. Given that level of risk, the process of finding the suitable asset class mix which can help the investor achieve his goal, is known as asset allocation. In conjunction to the idea of diversification, all asset classes may not perform well during the chosen time frame. Therefore, having investment in different asset classes in an optimum mix, enhances the chances of collective good performance, without assuming too much of risk.

Now that you have understood the importance of investing and how it can help you realize your goals, get your financial plan in place and see the difference!!!

Invesco Asset Management (India) Private Limited
Corporate & Registered Office: 2101-A, A Wing,
21st Floor, Marathon Futurex, N.M. Joshi Marg,
Lower Parel, Mumbai – 400 013
CIN No: U67190MH2005PTC153471

T: +91 22 6731 0000
F: +91 22 2301 9422
E: mfservices@invesco.com

To invest:
Call 1800 209 0007
SMS 'invest' to 56677

invescomutualfund.com

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