MONEY

Climbing Higher The rising interest rates will result in an increase in your outflows. What should you do to avoid the pain? By Krishna Gopalan **W**hen finance professional Viral Mehta, 35, bought a 1,200 sq. ft three-bedroom apartment in a Mumbai suburb, he pocketed a deal as the interest rate on his home loan was merely 7.25 per cent. His equated monthly installment (EMI) on a loan of Rs 38 lakh worked out to Rs 30,034. But that was two years ago. The interest rates then were at their lowest and Mehta got lucky with the bargain. Since then, the story has taken a turn. Rates have now crawled up to 9.75 per cent, pushing up Mehta's monthly outflow by 20 per cent to Rs 36,043. For Mehta, it was a surprising revelation. "Back then, I didn't foresee that the rates could go up so much," he says, "it has upset my monthly calculations."

**"A borrower should stay put as there are costs involved in moving from fixed to floating"**
Sudhin Choksey/Managing Director/Gruh Finance

Mehta's is not an isolated case. Scores of individuals have seen their monthly numbers go haywire due to the steady surge in interest rates. It's not just the housing loan rate that has been affected. Loan rates on cars and bikes and even travel have surged, especially in the last year. The effect of the rate hike has been particularly sharp as corporates have borrowed big, which has resulted in credit growth of over 30 per cent, while a dearth of depositors has squeezed the loanable funds of banks. Little wonder then, that retail loan giant, ICICI Bank, has affected two rate hikes this year and other public and private sector banks have followed suit. Rates are up by 50 to 150 basis points over the last year. Says V.S. Rangan, Senior General Manager, HDFC: "Housing loans are long-term commitments and during this tenure, there will be times when interest rates will move up and times when they move down. Two years saw the interest rates prevailing at an all-time low of 7 to 8 per cent. Today, the rates are hardening and are currently around 9.5 to 10 per cent."

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**The Rate Relationship**

DOS AND DON'TS

**Dos**

Keep a tab on the interest rate and what your resultant outgo is

Always read the fine print when going in for a loan. You could be in for a nasty surprise. And if you have doubts, ask someone who knows the subject

Go in for pre-payment of loan if you think you are sufficiently liquid. It is not a bad idea to get a big loan off your back early

Cater for contingencies. Your increased outgo each month is rarely the only significant outgo

Finally, prepare yourself for fluctuations in interest rates. It helps in better financial planning

**Don'ts**

Confuse yourself as being a real buyer when you could just be an investor. This really means that when you buy a house, for instance, make sure how long you plan to hold on to it

Acquire another asset without reason when rates are dropping. Make sure you need the asset and that you are liquid enough for a significant outgo

Move from fixed to floating or vice versa without a proper reason. There is a switching cost that is involved

Go in for savings without a proper reason. Remember, high returns on savings are the ones with high risks as well

Finally, never panic when interest rates are going up. If you are well-cushioned, you will be comfortable

Typically, there is little or no control that borrowers have over the rate of interest and this depends on the liquidity in the system and at what rate the lenders are borrowing their own money. For Mehta, the apprehension is understandable. "I hope the interest rates will not go beyond 10-10.5 per cent," he says with more than a bit of caution.

**"There is typically a cycle in interest rate movements and they will not rise forever "**
Jitender Balakrishnan/ Deputy Managing Director/ IDBI Bank

So, what does someone like Mehta now do? After all, increasing interest rates will impact every loan that he has borrowed. According to Puneet Chaddha, Head (Card and Retail Assets), HSBC, a borrower should always keep in mind the end use. "Any borrower should realise that rates can go up any time. It is important for him to cater for contingencies as well," he adds. By contingency, one is not always referring to an emergency but even something like going on a holiday. The basic idea is to keep some spare cash handy over and above a couple of EMIs to adjust the outstanding loan, so that the monthly installment is at a manageable level.

### Fixed or Floating

There is, of course, the option to move from floating to a fixed rate if the rate hike is too much. "For an existing borrower at this stage, I think he should stay put since there are costs associated with moving from one option to another," says Sudhin Choksey, Managing Director, Gruh Finance. He agrees that 2006 was quite volatile as far as interest rates were concerned and for now, a "wait and watch" attitude from the borrower's side seems like a smart thing to do. "For a new borrower, I would suggest a semi-fixed option as the best bet," avers Choksey.

These days banks have started a hybrid of fixed and floating rate home loan products where a part of the outstanding is fixed and the other is floating. Says Rangan: "The loan will be broken up into two parts-one on which interest is charged at a fixed rate and the other on which interest is charged at a floating rate." Such products will help reduce the impact of the rising interest rates.

**"Any increase in the loan tenure should not go beyond one's earning years or one's retirement period"**
V.S. Rangan/ Senior General Manager/HDFC

For the likes of Mehta, "wait and watch" seems a prudent thing to do before switching. Sunil Rongala, Group Economist at the Chennai-based Murugappa Group, is of the opinion that when it comes to home loans, he would still go for floating. "I think rates will come down since India is not a classic inflation case like that of Argentina. Besides, inflation is certainly not out of control here in India," says Rongala.

Alternatively, an individual has the option of increasing the tenure of the loan as most banks are doing. But one must always keep a tab on the outstanding and pre-pay a part of the loan or increase one's EMI so that the extended tenure does not stretch for too long. Says Rangan: "Most institutions reset the tenure of the loan if there are any interest rate fluctuations rather than change the EMI to avoid any immediate impact on the customer. However, in such a scenario, the customer should be cautious that the increase in the loan tenure does not go beyond one's earning years or one's retirement period."

### On the Rise

Most industry observers are clear that while the interest rates are hard to predict, the phenomenon of them rising continually is equally unlikely. "There is typically a cycle in interest rate movements and they will not rise forever," maintains Jitender Balakrishnan, Deputy Managing Director, IDBI Bank. On the issue of fixed versus floating rate of interest, he points out that while the rate of interest is normally higher on fixed, the rate on floating can be changed according to the Prime Lending Rate (PLR). "Interest rates could probably increase by a quarter-to-half-a-per cent and then stabilise over the next few months," predicts Balakrishnan. That should sound good to the borrower since his actual outgo through the EMI will most importantly be predictable. So, even while there's a chance that it could stay stable, borrowers could do well to brace themselves for the hike.

The need for the borrower to think smart and opt for a loan amount that is within his capacity can never be exaggerated. Pre-payment of a loan is surely an option if the borrower has a larger amount of disposable income at a particular time against what he requires. "Yes, pre-payment of a loan is an option if there is a difference in the rate of interest," cautions Balakrishnan.

All this would depend not merely on the current level of liquidity but also on the future cash flows of the borrower. After all, a hefty outgo in case of Mehta and several thousands of others would lead them to take a closer look at this unpredictable area. "Salary increases may not be that high," states HSBC's Chaddha. On the issue of pre-payment of a loan, he maintains it depends on the mental make-up of a person. "For instance, if a person is close to retirement, it is a good idea to pre-pay a loan," he adds.

At the end of it, the India story looks real and that is clearly the reason for this kind of liquidity. As far as the interest rates story goes, the consensus seems to be that we are entering a zone of stability, which is good news for the borrowers. However, like any other phase in a country's development process, a certain amount of caution is not only a good idea, but also necessary. A basic degree of financial planning acts as a good cushion for any individual against interest vagaries and that could well be the answer this time around as well.

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Don't Churn Your Funds

The high incidence of churning in equity funds is alarming and is detrimental to long-term wealth building.

By Mahesh Nayak

If there's an alarming side to the fund flows of equity mutual funds, it's this: a high churn ratio suggesting that short-term investors far outstrip the long-term ones. Last year, a record Rs 64,169 crore was redeemed from equity schemes by investors flipping out of funds, nearly twice as much as Rs 35,000-odd crore garnered by new fund offerings (NFOs), and more than 66 per cent of the entire inflows of Rs 97,834 crore during the year (see The Churning Ground). For equity fund investors, that's a worrying sign. First, there's a tremendous amount of pressure on the fund manager to perform. And secondly, excessive churning does more harm than good to your long-term wealth building.

**"You have to give time to your fund manager to perform and have faith in his investment call"**
Sanjay Sachdev/
Country Manager/
Shinsei Bank

Last year, however, the market regulator, the Securities and Exchange Board of India (SEBI) came down hard on new mutual fund offerings. SEBI even mandated that the trustees should endorse new funds saying that the fund house does not already have a similar type of fund. The Association of Mutual Funds in India (AMFI) too reintroduced the reduction of a fund's initial expense upfront as against amortising it over a five-year period. But that does not seem to have deterred the mutual fund investor from switching between funds- often at an additional cost that's detrimental to him.

How Churning Hurts

**What you should know before you churn your funds.**

Sustained churning disturbs the investment rhythm of the fund manager forcing him to make aggressive choices and increase risk to the overall portfolio

Short-term churning erodes maximum gains for investor due to short-term tax of 10 per cent and higher loads

Churning should be considered as a tool to rebalance or realign an investor's portfolio

As far as the mutual fund industry goes, the blame game is passed around. The mutual fund industry points a finger at the distributors for mis-selling a product, which later pushes an investor to move out while the distributor passes the same on to the retail investors indicating that the mutual fund investor is now more demanding and therefore is willing to shuffle between funds. Even as the industry squabbles, more investors are pulling out of new funds. Interestingly, the corpus of 27 open-ended equity NFOs launched in 2006 dipped by 18 per cent to Rs 20,641 crore from Rs 25,271.9 crore, despite the market rising. Kotak's Lifestyle Fund saw its corpus reduced by 55 per cent or Rs 385 crore from a mobilisation of Rs 856 crore. In the same period, the Sensex has surged by 35 per cent (see Corpus Capers).

Often investors get carried away by the booming market making aggressive investments by churning their existing portfolio. Says R.

Swaminathan, National Head (Mutual Fund), IDBI Capital: "It's a herd mentality. When returns aren't good and markets are rising, investors tend to change from one fund to another. Secondly, profit booking has also kept the churns at higher levels." Adds Sanjay Sachdev, Country Manager India & Regional Manager (Fund Management), Shinsei Bank: "The industry is still dominated by large investors, who have short-term goals adding to the churning, thus spoiling the real purpose of investment."

The Cost of Hopping

Among the many drawbacks of switching funds, the foremost is the pressure of performance on a fund manager. They have to be constantly on their toes to deliver returns that can hold back their investors and they can't simply be patient with solid long-term investments. If a fund is lagging behind in performance, investors tend to cash out which therefore forces a fund manager to look for far riskier equity investments. Says Swaminathan: "It disturbs the investment rhythm of the fund manager." On the other hand, some investors have also begun to speculate in mutual funds. A small percentage rise in the NAV (net asset value) sees an exodus from the high net worth individuals to other NFOs.

But nowadays, apart from an entry load of 2.25 per cent, investors also pay an exit load. It's the investor who bears the additional costs which shave off close to around 4 per cent in his overall returns. Additionally, investors also have to bear the brunt of the initial issue expenses which are reduced in the NAV of the fund.

Much of the churn seems to arise from the myth of whether a Rs 10 NAV is cheaper than say a Rs 100 NAV. In reality, both are the same because the underlying investments are at the current market price. More launches of new funds have been among the reasons for a high churn rate. It's the level of the market (Sensex) that determines if investors have entered at lower or higher levels, not the NAV of a fund. Says Sachdev: "It's not that investors aren't feeling the pinch of churn, but being financial illiterate, they blindly follow distributors and are always caught on the wrong foot."

Also, consider taxes. Every time you churn your portfolio by moving from one fund to another in less than a year, there's a liability of short-term capital gains tax at the rate of 10 per cent. For instance, assume an investor enters a fund at an NAV of Rs 20 per unit at the index level of 10,000 in the month of June. If the market rises by 10 per cent in September, the NAV surges to Rs 22 per unit. If the investor decides to move out by booking profit and entering another NFO at Rs 10 per unit at the index level of 11,000, he is a clear loser. Here's how? An investor will have to pay a 10 per cent tax, which will result in net returns of 9 per cent post-taxes. Add to that the exit load that can range from 1 to 2 per cent.

Apart from a direct loss of the investible surplus, there's also an indirect loss of time besides an opportunity cost of staying out of the market. Much of the gains go in vain as the deployment of the money mobilised through an NFO takes at least two-to-four months. If the market rises further during the process, a fund manager is likely to buy the same stocks at a higher price only adding to your costs.

If you must switch out of a fund, make sure that's it for a long-term goal like rebalancing your portfolio rather than a short-term one like profit booking. Says Hemant Rustagi, CEO, Wiseinvest Advisors, "switching can be necessary at times. You can't invest in equity and sleep over the investment. There is a constant need to keep a watch on your portfolio, if there is a need to rebalance asset allocation." For instance, in a situation when mid-caps aren't doing well, investors should realign their portfolio and move into large-cap stocks.

Short-term churning will only add to the constant pressure of keeping a tab on your investments and worrying about its performance daily. Says Sachdev: "Investors should determine their goals and have a minimum investment horizon of three years, than speculating in funds. You have to give time to your fund manager to perform and have faith in his investment call." If you want to build wealth over the long-term, stay put.

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NEWS ROUND-UP
A Golden Opportunity

Gold ETFs are set to debut in India. What does it mean for you?

By Mahesh Nayak

The market regulator has given investors one more reason to smile. On January 17, the Securities & Exchange Board of India (SEBI) gave the green signal to two Indian fund houses-Benchmark Mutual Fund and UTI AMC-to launch Gold Exchange Traded Funds (ETFs). India will be the fifth country in the world after Australia, US, UK and South Africa to launch gold ETFs. What this means is that investors can now invest in gold just as they do with mutual funds.

Gold ETF Basics

**Exchange-traded funds are mutual fund schemes that are traded like shares on stock exchanges and are a proxy for a market index, a sector or a commodity**

Gold ETFs will hold gold as the underlying asset

These funds will be linked to gold prices and will not be actively managed

Investors can opt for Gold ETFs instead of directly holding gold bars or ornaments

**Paper Gold**

A gold ETF is an exchange-traded mutual fund unit listed and traded on a stock exchange, just like stocks. Gold is the underlying asset for the units of that fund. Every gold ETF unit represents a definite quantity of pure gold and the traded price of that unit moves in tandem with the price of the metal. Unlike in the commodity market where gold trades on a future date, trading in gold ETFs is done on a spot basis in electronic form, and the settlement period is T+2 (the day on which trading is done plus two days). Another advantage: the gold ETF is a piece of paper that can be dematerialised just like a normal share. In contrast, the gold that investors buy from commodities exchanges comes in the form of ingots, bars, biscuits and coins, making physical transfers costly and risky. Says Rajan Mehta, Executive Director, Benchmark AMC: "In principle, buying gold ETFs is similar to buying securities in the equity market. The benefit is that investors can buy really small quantities-as low as one unit, which is the equivalent of one gram of gold-unlike in the commodites market, where he has to buy minimum 10 gram, and that too, in physical form."

**Small Investors to Profit**

ETFs aren't suited for those who want to buy gold for making ornaments or for other manufacturing purposes as the securities cannot be exchanged for the underlying metal. It is meant for investors who wish to diversify their portfolios to minimise risk from external factors. This effectively means that institutional and high net worth customers, who want to consume gold, will not enter this market. In 2006, India, which is the world's largest gold market, imported an estimated 800 tonnes of the yellow metal.

According to the new regulations, gold ETFs will be treated as debt MFs. This means short-term capital gains will be taxed at 30 per cent and long-term capital gains at 10 per cent. Incidentally, physical gold worth over Rs 15 lakh attracts a wealth tax of 1 per cent per annum. Apart from the investment angle, gold ETFs are safer than buying gold from commodity exchanges as investors don't have to worry about purity. The custodian will have to get the 99.995 purity gold in his custody certified. Secondly, the gold bought will also be insured to secure the value of the ETFs.

The valuation is done on the basis of the morning price quoted on the

London Bullion Markets Association (LBMA) in us dollars per troy ounce for gold having a purity of 995 parts per 1,000. It will be subject to the adjustment for conversion to metric measures as per standard conversion of us dollars into rupees according to the RBI reference rate declared by the Foreign Exchange Dealers Association of India (FEDAI).

Despite having approvals in place, the funds are still about one-and-a-half months away from launching gold ETFs; so investors who want to trade or invest in them will have to wait for a while.

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**Not Just Another Binge**
There's a cost to splurging. So before you pull out your wallet, check what you could lose.

By Clifford Alvares

Want to know how you can turn unnecessary extravagance into a fortune? It's not that difficult and it certainly is not hard work, but it only involves a little sacrifice, particularly if you are among the big spenders as Usha Thorat, 36, a businesswoman discovered. Over the years, Usha developed a habit of buying, among many other things, over 100 pairs of branded shoes of over Rs 1,000 each. She also purchased over 50 pairs of expensive glares, 25 watches, and more than 300 sarees. That apart, off late, Thorat has been flipping mobile phones and she has changed about 20 models so far.

It's not that high-flying Thorat has used all the things she has purchased. Some of the shoes and sarees have been lying unopened for years. Besides, she also has the habit of buying books and eating out at classy restaurants. And all this is costing her a tidy sum of money. Not only is she spending about 50 per cent of her current income of Rs 1 lakh, she's also blowing away capital creation of the future.

**Effects of Splurging**

There's a far bigger loss of money for Thorat. In fact, a steady accumulation of money into savings instruments such as provident funds or equity mutual funds and stocks can turn to a tidy sum over the years. Instead of buying your next new mobile phone, just sock away that money regularly in a mutual fund. It's among the most simple forms of accumulating money and it can turn your thousands into crores over the long haul.

Consider this, if you are smoking a pack of Marlboro Lights every day, your cost per day is Rs 80, which works out to Rs 29,200 per year. Instead, had you invested that money every year in, say, a provident fund account that gives a return of 8 per cent per annum, you would have a tidy corpus of Rs 33,07,870 over a 30-year period. The aggressive investor could instead choose to invest in stocks where, if the returns are in the range of 20 per cent per annum for the next 30 years, the accumulation is a little over Rs 3.45 crore (see The High Cost of Splurging).

One main reason for the growth in the corpus is due to the benefit of compounding. Over the years, interest accumulates on the interest which accumulates more interest and that helps to build a tidy sum of money in the long run. The accumulation tends to multiply rapidly as the years progress, which is why even a small sum turns into a fortune over the long term. If you eat out every week and spend around Rs 2,000 per week, it tots up close to Rs 1,17,81,453. The magic of compounding works best over longer periods of time. If you invest the same amount of money for, say, a period of 20 years as against 30 in the above example, you will accumulate Rs 47,59,244. But instead, if you sock that money away for 35 years, you would have added more than Rs 1.79 crore to your net worth.

One need not necessarily target only the big ticket items for cost cutting. But you can also tackle other weekly routine areas such as hiring a video or taking your car out for a long weekend drive. It's a matter of finding that wasteful expenditure and taking steps to cut it down.

**Tackling it**

But before you do that, you need to have a defined goal and plan to find areas that require cost-cutting. If too much of money is spent because of the credit card, then you should be willing to give it up or risk spending more against it. Your plan can identify the spending areas that are not important or which can help you identify the debt that does more harm than good. It's best to avoid making spontaneous purchases. When you go shopping, go with a list and don't buy anything that is not on the list.

The next step is to find out how you can make investments easy and hassle-free. These days, with most of the banking done online, most websites offer a host of services to manage your money. So in terms of alternatives, there are many options that you can choose to sock away the extra savings. But among the easiest is to regularly invest in a mutual fund through the systematic investment plan (sip). It's not too much of a hassle as the funds will automatically get debited from your bank account into the fund at that day's NAV.

Start saving with small amounts and see it grow. Once you find an investment that you are comfortable with and see how it accumulates over, say, a six-month period, that will encourage you to stick to your savings plan. If you do that for a 30-year period, even with small amounts, the results are gigantic. Thorat's just begun on the savings journey. So, start now.

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**Where There Is A Will**

Ensuring the right inheritance of your legacy is easier with a will. Here's why and how you should write one.

By Nitya Varadarajan

**"A will should be spelt out clearly and should be without ambiguities-then there is no room for the inheritors to squabble among themselves"**
Kalyan Jhabakh/ Senior lawyer/Surana & Surana

When you want to distribute your wealth according to your wishes after you are gone, there's one thing that you must write out: a will. There are obvious benefits to executing a will well in advance. It ensures fair treatment of your property. As is often the case where there's no will, the heirs squabble among themselves for inheritance. You must spell out a will between 30-35 years, if you haven't done so earlier-since the unexpected can happen any time. You can always re-fresh wills or alter the existing one at later dates depending on changed circumstances. And if you are older, it's never too late to make one.

**The Process of Willing**

There are two types of wills- oral and written. An oral will is when a person speaks his intentions aloud in front of witnesses. But in an oral will, there's a possibility of misinterpretation, unless the witnesses are impeccable and fully understand what the person wishes. Besides, it helps to articulate your will clearly. Says Kalyan Jhabakh, senior lawyer at Surana & Surana: "A will should be spelt out clearly and should be without ambiguities-then there is no room for the inheritors to squabble among themselves." And a written will goes a long way in ensuring that. "A hand-written will, with some foresight and planning, is much better,'' he adds.

A will can be written on plain paper and needs two witnesses- the last being compulsory. It has to be made under 'one's free will and without pressure'. You can register it with the state authorities for a nominal sum (around Rs 100) where you can be sure that it will be safe. Usually a sealed envelope is given to the registering authority, which makes note of the date. During execution, the court will call for it and make the intentions of the deceased known.

Why it is important to make a will

**Your property gets distributed in accordance with your wishes**

It ensures that your heirs are not left with a muddled state of affairs to decode and decipher

It ensures amity in the family even if there may be disappointment in some quarters

It cuts down on additional and unnecessary legal expenses by your heirs on account of squabbling and disputes in asset distribution

Ensures that your heirs don't curse you just because you neglected making a will even though they will eventually inherit your property

In case of minor heirs, money can be fuelled into a trust and handed over at an appropriate date

If there are several registered, the last is always taken. Even if the deceased is not able to register his final will, as long as he makes it clear that this one is the last and is making amendments to the previous will that was registered, the will should sail through smoothly.

Every will needs an executor who probates the will and who is quite often the key beneficiary. An executor could also be a neutral member, usually nominated by the maker of the will. It is always the executor who has to prove the validity of the will, if challenged. If the assets are substantial, it is better that one consults a lawyer and accounts for the same carefully. It's necessary that the person remembers his assets and their value as any lapses on this count could result in disputes among the inheritors.

The probation period before the will is finally accepted generally takes five to six months-the court follows a formula so that people are given enough time to make their objections. It also allows the will to be viewed by all the parties concerned. The process takes a little while, but not much can be done about it. If there is immovable property involved, the court satisfies itself on property assessment through its valuers. A court fee has to be paid on that valuation-in a metro, it is usually 3 per cent of the total value or Rs 3,000 for every Rs 1 lakh.

If the inheritor leaves behind a large house to the beneficiary and executor, the latter will have to cough up high court fees, but the same can be provided for in the will. (In today's spiralling real estate and property costs, this has to be considered.) If all the inheritors agree with the will (i.e., amicable acceptance), then on that basis, a family settlement can also be arrived at, which can be done out of court. A lawyer is not really needed for this, but somebody with experience of arbitration and such matters is a must. The other inheritors sign an affidavit releasing their right to the immovable properties and make it over to the 'willed' inheritor. These affidavits have to be registered with the local state authority-but this process could sometimes work out cheaper. Tamil Nadu, for instance, has fixed a cap of Rs 10,000 for family settlements, irrespective of the value of the property.

However, it must be noted here that nobody can subvert a will and arrive at a family settlement just because they don't happen to like a clause by the deceased. If a real will crops up later, that could lead to litigation.

Usually, wills get probated in the place where the deceased resided last, but in case of NRIs, special provisions are made for their property in India. If there's no will, the disputes are heard in courts where the property is located, which, of course, could be inconvenient for an outstation inheritor. If a person has not left behind a will, then the estate is divided equally among the family members. And if you don't want that to happen, make sure you will your property to the people you want.