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MAX SECURE FINANCIAL PLANNERS—NEWSLETTER

Nurturing Trusting Relationships

Stress Test in Personal Finance

You must have heard of "Stress Test" carried on American and European banks during the 2009 crisis which brings out the reality on under-capitalisation of banks and how prepared they are to face unfavorable economic scenario. As per Investopedia, bank stress test is an analysis conducted under unfavorable economic scenario which is designed to determine whether a bank has enough capital to withstand the impact of adverse developments. The basic reason for doing the same on banks were to find out that how much they are exposed to Credit Risk, Market Risk, Liquidity Risk, etc and how better or worse they can perform or manage in such kind of crisis. Since then stress test is used to evaluate the strength of the financial institutions.

Stress test in Personal Finance

Crisis is not limited to Economy or corporates. Whatever is happening in the economy is directly or indirectly affecting us. Moreover in our personal financial life, we face so many situations affecting our financial situation like job loss, health problems, car break down, accidents, sudden rise in children's school fee etc. so it becomes inevitable that we should also pass through a stress test to find out how prepared are we to face or manage such kind of crisis. Stress testing is a useful technique for determining how a portfolio will fare during a period of financial crisis. Now portfolio can be of any type like Investments portfolio, Income portfolio, expenses portfolio, insurance portfolio etc.

How to do a Stress test on Personal Finance:

1. Write down your financial situation in detail

a) Your income from all the sources,
b) Expense details like your monthly rent, children's school fees, House expenses, vacations etc.,
c) Your asset details like your financial assets, Real assets etc.,
d) Your liabilities details like your EMIs on home loan, personal loan, car loan etc.

2. Brainstorm and write down some simulation scenario question.

a) What percentage different sources of income carry in total income portfolio and what effect it will make in your personal finance if one or two sources get stopped?

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Inside this issue:

Financial Gyan

Meeting life goals requires consistent, committed, disciplined approach towards one's finances. Contrary to popular wisdom, modest savings build a huge cash-pile and helps meet goals, which seem impossible, at first glance.

Prakash Praharaj, CFP^{CM} CPFA

Hedged, to face any medical situation?

Life is very fragile and even more so is health. Most of the times people take life and health for granted and assume that things are always going to be fine and therefore also take planning for life and medical covers very lightly.

Life is becoming very dynamic in every sense with each passing day, be it in the area of work, relationships or health and yet people risk health for the sake of work or money. Then they spend that money to artificially restore health with medication, helping and enriching only the medical fraternity. Though mankind has evolved and progressed very fast and is capable of innovating medical solutions for various medical conditions, it has failed to keep up pace with the ever changing and evolving viruses that infiltrate our bodies. Sometimes these viruses occupy a place for a long time, even till the last moments of life, creating damage beyond repairs. This thought itself creates nervousness and can have devastating impact on the family, their future and finances.

Medical conditions where the outcomes are beyond the control of the medical profession.

⇒ Dialysis, cancer which needs recurring medication, restrictions on movements & deteriorating physical condition with limitations in employability.

⇒ Paralysis requires long recovery periods with continuous monitoring and medication leading to bed rest & total dependence resulting into unemployment and concern for the rest of the family.

⇒ Heart aches, diabetes leads to continuous diet monitoring, careful movement and other limitations.

All the above conditions result, most of the times, in reduction of earnings & working capacity for longer periods and sometimes in its discontinuation also, which invariably necessitates alternate resource requirements for the family. In such circumstances the rest of the family has to shoulder not only the day to day expenses, but also the additional ongoing medication costs along with the future requirements such as education, marriage etc. and any shortfall can lead to a compromise. Even if the full family is insured one needs to understand in advance, that the medical cover does not take care of expenses such as second opinions, travelling to and fro for various tests and the time spent by attendants, besides being mired by limitations by way of a cap on the cost shared by the insurer among other things.

Some prescriptions to avoid possible disasters:

1. Prevention is always better than cure. Health first, nothing can beat this. Every family can work as a team and be aligned to the goal, which certainly calls for review of the:

⇒ Day to day workouts and exercise habits

⇒ Food habits

⇒ Stress

2. Medical history – analysing family's medical history, every individual's existing medical conditions, understanding and accordingly deciding the strategy

3. Medical cover – based on the above

⇒ The quantum of coverage required, Individual policy or Floater one, further wherever one has the employer's cover, is it enough or should one go for an additional personal policy now or in the future

⇒ The limitations of the policy with respect to coverage of conditions, limitations of amount covered etc.

4. Critical illness cover – should be specifically opted for based on family history and wherever affordable.

5. Medical corpus – comes in very handy in cases like:

⇒ No coverage due to age or existing ailments or limits in the policy

⇒ Continuous care and medication is required for longer periods of time

⇒ Discontinuation / partial continuation of regular work either of the effected or the caretaker.

6. Continuity of income – in extreme conditions, calls for someone to take over the role to run the show or bear the additional burden, besides providing the care and support. So a qualitative check about the employability in the family – is the spouse ready and capable enough to take over the burden of the family and to lead it through the situation future, if necessary?

7. Support systems – With the weakening of the joint family system, relationships counts all the more, if maintained and reciprocated well with family, friends and colleagues. The support provided can be in terms of:

⇒ Financial

⇒ Physical presence during hospitalisation since one need to attend the affected as well as the ones at home or school etc.

⇒ Understanding the nitty-gritty with the hospital and attending doctor and medical cover formalities

8. Financial literacy – comes from continuously sharing on aspects like investments, liabilities etc. Awareness and readiness helps families to align better on various aspects like health, lifestyle, finances, understanding, overall growth etc. and deal with such disasters better.

Understanding Systematic Withdrawal Plans

Systematic Investment Plans (SIPs) have become a common terminology in most cities now. People use SIP as a generic name for mutual fund investments. We commonly hear people say they want to invest in SIP, like asking for Colgate when buying toothpaste or Bisleri for bottled water. Systematic withdrawal plan (SWP) is comparatively an unknown entity.

What is SWP?

In essence, SWP is the reverse of SIP. Where in SIP you look at accumulating a corpus by making regular investments into a fund, in SWP you regularly withdraw a fixed amount of money from a fund. The amount to be withdrawn and the frequency is fixed by the investor. So you can have a monthly, quarterly or annual frequency for any fixed amount that you wish to receive.

In SIP you look at accumulating a corpus by making regular investments into a fund, in SWP you regularly withdraw a fixed amount.

Mr Gupta would be very happy to receive a fixed amount in his account every month, when he retires. Anchal is currently on a sabbatical to bring up her baby. She would be thrilled to put her savings to use for generating a small regular income flow for herself. SWP can help Mr Gupta and Anchal plan their cashflows. This is one of the many methods available for generating a regular income from your savings.

Let us look at some examples of how this strategy will work. Say Mr. Gupta has Rs.10 lakhs which he wants to use for generating income through SWP. Let's look scenarios with investments in three different type of funds.

⇒ **Amount Invested**: Rs 10 lakhs
⇒ **Systematic withdrawal amount**: Rs 10000 per month
⇒ **Date of SWP**: 2nd of every month
⇒ **Start of SWP**: 02 Feb 2010
⇒ **End of SWP**: 20 Feb 2013
⇒ **Total amount withdrawn**: Rs 240000

For simplicity we have taken three funds from the same fund house and not considered taxation in these calculations.

Balance in Folio as on 4 Feb 2013:

⇒ HDFC Top 200 Fund (G): Rs 9.07 lakhs
⇒ HDFC MIP LTP (G): Rs 8.71 lakhs
⇒ HDFC Income Fund (G): Rs 8.39 lakhs

Let's look at a hypothetical case where you invest Rs 10 lakhs and the fund gives a return of 9%p.a. You run a SWP of Rs 10000 per month. In this case your funds will last you for 182 months. That means will be funding more than 15 years of your needs. In this case, if your annual withdrawal is less than the expected annual rate of return, then the SWP can run to perpetuity. So if our fund can be expected to give 9% return, if you draw only 7-8% of the invested corpus every year, you can use your one time investment forever.

Let us look some other popular fixed income products which are the Senior Citizen Savings Scheme (SCSS) and the Post Office Monthly Income Scheme (POMIS).

Cont.... Page 4 (SWP)

Cont. Page 3 — SWP

Both these schemes offer guaranteed returns. But they also have limitations in terms of amount, period and mode of holding. SCSS allows maximum investment of Rs 15 lakhs in one name and is currently offering a rate of 9.3% p.a. Which means you can get a minimum monthly income of Rs 7750 from this source. Similarly POMIS allows maximum investment of Rs 4.5lakhs in single name and Rs 9 lakhs in joint name. Current rate of return is 8.2%. Hence the maximum monthly income from this source can be Rs 6150. Both these incomes will be fully taxable as per the tax slab applicable to the investor.

So while the income is guaranteed and regular, there are other restrictions. In such scenarios, SWP option of MF becomes a strong contender for a place in the portfolio as a big support to these options.

Benefits of SWP

Regularity: With an SWP, you are assured of getting a fixed amount at your pre-determined frequency. The problem with other options like a monthly income plans, which pay dividends, is that the amount and the frequency of the payouts is not fixed. Sometimes, if there is no appreciation which can be distributed, you might have no dividends to be paid. Hence every month you will have different amounts coming in and some month there might be no money received.

Taxation: SWP is better from the taxation point of view too. In debt funds dividends are paid after deduction of dividend distribution tax (DDT) of 28.32%. So that will be your tax in case you depend on dividend income from your debt mutual funds. In case of SWP, you will pay a short term capital gain (STCG) or a long term capital gains tax (LTCG). Though STCG may be more expensive as it is on the income slab of the investor, LTCG will be beneficial as it is a fixed rate of 10% or 20% with indexation. Things get better in case of SWP from equity funds. As the long term capital gains from equity mutual funds are exempt in case of holding beyond a year, you end up paying no tax on the withdrawals.

> **The only drawback in the SWP is that it will at some point eat into your capital. So you need judicial mix of investments.**

Inflation Protection: Most of the fixed income instruments do not offer inflation beating returns. So, though the principal may be secure, the income might fall short of needs in future. Here again SWP scores in terms of generating returns to keep up with inflation especially if you opt for an equity fund.

The only drawback in the SWP is that it will at some point eat into your capital. But judicious mix of investment instruments will ensure that your primary goal of income generation will be met without you running out of money in times of need.

So the conclusion is that SWP is a noteworthy strategy to use for generation of regular income in various scenarios.

How to improve your Credit Score

How irritating and annoying is this for someone who is earning a decent salary, working with one of the best employers of the world and that too at a senior level, to see his loan application get rejected. Unbelievable!! Isn't it?? But it actually happened with one of my good friends. The reason quoted by the bank is Bad Credit score. Yes, these days besides looking at the income part, loaner always refers to the credit score of the applicant before passing on any loan application.

What is Credit score?

An individual's Credit Score provides a lender with an indication of the "probability of default" by the individual based on their credit history. The Score tells a lender how likely you are, to pay back a loan (should the lender choose to sanction your loan) based on your past pattern of credit usage and loan repayment behavior. This Credit score is maintained by CIBIL.

How credit score can be improved:

One should have a clear understanding onto the factors affecting one's credit score, so that he does not make mistake unknowingly for which he has to repent later on.

1. Loan Repayments/defaults history : This is the most important among all the factors to leave an impact on your credit score. If ever you have made any default in paying EMIs on any of your credit facility like personal loan, car Loan, home loan etc. your credit score is bound to be negatively affected. Even if you are in a habit of paying minimum balance as it indicates that you are having trouble servicing your existing obligations.

Solution to this could be to pay your EMIs on time. Never use credit card to such an extent that you are not able to repay it in full. Better to put reminders on your phone, mail which reminds you of the due date. Also it is advisable to issue the payment cheque 4-5 days in advance so that it gets credited on time to the loan/Credit card a/c.

2. High utilization of credit limit: Be in limit while using your credit limits. Keep your balances low. High utilization of credit limit is viewed as high burden on your repayment capacity and thus puts a negative impact on your credit score. If at all you are in emergency then better to divide the usage in 2 cards (if you have).

3. Higher percentage of unsecured credit: Personal loans and credit cards come under the category of unsecured loans, as you don't have to give collateral against these loans. Being expensive, it requires more outflow in terms of repayment, thus high percentage of these loans in your loan portfolio history puts negative effect on your credit score.

Better to keep a healthy mix of all types of credits like car loan, home loan etc. and use judiciously.

4. Don't be credit hungry : The number of enquiries you have made for loans which also includes the request by you to increase your credit card limit is viewed as you are in badly need of loan. Even if you are using some of the credit facilities a lender is likely to view your application with caution. This credit hungry behavior indicates that your debt burden has or is likely to increase and will put pressure on your repayment capacity going forward.

So don't play with your credit score with saying yes to all preapproved loans, applying for all lifetime free credit cards, taking personal loans to give down payment for house along with taking home loan etc.

5. Cancel your credit cards: While using more of credit card is viewed negatively by CIBIL, having more cards also viewed as more liquidity available. Though you should not apply for more cards, but if you have many then you may consider cancelling few and keeping few.

6. Help with wisdom : Many times it has been seen that to help a friend or relative we are in a habit to give guarantee or become a joint applicant to the loan application. But in future, do it with caution, as any default made by the actual user will put negative impact on your credit score also. In co-signed or jointly held accounts, you are held liable for missed payments.

7. Review your credit history timely : Keep abreast with your credit score. Make it a habit of applying for your credit score every year, so you should take necessary action wherever required.

The above mentioned points are important to improve your credit score, but please note that every loan provider have their own process of sanctioning the loan. This credit score is just referred to view the credit history of the applicant. Ultimate decision remains with

Cont... Page 1 Stress Test

For e.g. what if Rs 10,000/- p.m. that you get from your tenant suddenly stops…would you be able to continue with your EMI payments?

b) What percentage different areas of expenditure carry in total expense portfolio and what effect it will make in your personal finance if there's a sudden rise in one or two areas for e.g. what would be your personal finance situation if suddenly your kid's school fees rise by 50% and which carries around 10% weightage in your total expense.

c) What's the liquidity situation in your assets portfolio? This means what percentage of portfolio is immediately liquidable in case of emergency requirements for e.g. if you suddenly met with an accident, then do you have enough liquidity to manage the family expenditure or you suddenly get a call that your cousin/nephew has got engaged and marriage is planned next month…are your finances ready to manage such sort of sudden expenditures.

d) What percentage different assets carry in your investment portfolio and how volatile your Investment portfolio is? What affect your Investment portfolio will have if there's sudden fall in the stock market or due to a government policy effecting real estate market.

You have to do some brainstorming yourself or with your family members and other stake holders to find out different simulations. You may also take the help of financial planners.

3. Find out the best possible answers to these questions

Like for the question asked above, if you have enough liquidity, sources of income, proper asset allocation in investments, adequate insurances to fall back upon with which you may not feel pinch in any of the crisis situation then it's completely fine .You passed the test. But if in any of the situation you don't have the comfortable answer then that is the cause for concern.

What if you can't pass your own stress test? Unlike a bank, you probably can't go out and raise more capital, unless your relatives are very generous. There are some ratio analysis techniques which can help you figure out what should be the liquidity position in your assets, the maximum debt you should take and many other things

But ultimately this is you who have to work on the situation and bring your finances in order. You can reduce your spending, pay off your costly loans, Follow a proper asset allocation approach and do goal based investing, diversify your investments or you can set up a line of credit for use in emergencies.

See, there's no requirement of having every penny that you would need to get through a crisis. But figure out how much you will have, how long it will last and where you could get some help if circumstances beyond your control hit your family's finances. You should not wait for any unfavorable situation to do such test as what Americans have done. It's better to learn from other people's mistakes and do a stress test on your own personal finance to manage the uncertainties confidently.

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About Us

Max Secure Financial Planners, by providing fee based advice, are not only independent of product sales but also provide unbiased recommendations by keeping the clients interest uppermost in mind by creating a road map leading to their financial freedom.

Vision

To provide affordable fee based financial planning services, by adhering to professional practice standards and Code of ethics as prescribed.

Mission

Nurturing and maintaining long-term relationship based on trust with clients by keeping their interests uppermost in mind, providing unbiased advice & financial planning services using six steps planning process, promoting financial literacy.