

Financial Goal-based Investing

When we take our family on a holiday, we make several plans – for travel, stay, sightseeing, equipment, food, and other expenses. Many of these decisions however depend on a crucial factor – our travel destination. If we travel to Ladakh we will carry woolens and trekking equipment; if we went to Goa we will pack sun screens and swimming costumes. Our travel plan is defined by the destination. Similarly, our investments have to be defined by our financial goals.

We may have a long list of things we like our savings to achieve. Educating our children, getting them married, planning for a comfortable retired life, owning a home, re-doing our existing homes, funding our holidays, and so on. These large ticket items that cannot be met with our regular income require us to set money aside. But saving alone may not be enough - we need to plan about how to invest those savings, so that we are able to meet the goal we have in mind. Such an approach is called financial goal-based investing, and is a useful way to plan and provide for several critical large expenses that we have to incur.

Consider for example, the education of the children. We may begin to set aside some money for them when they are young. But choosing an investment plan requires an understanding of three things. First, we define the goal in terms of amount of money and time. Assume that we like to save for the child to pursue a professional course, after 16 years. We know that it costs, say, Rs.1 lakh a year today. We need to consider the effect of inflation on this goal. Assume we estimate an inflation of 6%. That is the minimum rate of return our investment must make, so that the amount grows at least to cover the effect of inflation. Second, we need to understand how much we can save per year for this goal. This depends on our income and expense patterns and our seriousness about this goal. Third, we have to choose an investment option that generates enough return to meet the goal.

We either increase the savings or we choose a higher return yielding investment, and balance the two. Too high savings may be impractical; too high an investment return may be risky. We therefore have to consider the time on hand. Longer the time we have, greater is our ability to choose higher return and higher risk investments. If the return on our investment is high, the same goal can be met with lower amount of saving, freeing money for other goals. A slow train will be less expensive, but take us time to reach. A flight will reach us to the same place faster but costs more. We have to make the same choice with our investments, based on the time we have.

Mutual funds aims to fund our financial goals by offering a range of products that help us earn income or achieve growth over a long period of time. Goals give our investments a purpose and make it easier to choose our investment vehicles.

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