

Article 1: Time value of Money

Your grandfather tells you that he earned a princely salary of Rs.250 per month, which was then lot of money. He regales you with stories of how his meal cost Rs.2 and how rents were only Rs.10 per month. It sounds incredible. You then consider the sad truth of his current situation. With a pension of Rs.2500 a month, he is hardly financially independent. Why did the comfortable lifestyle of his youth of turn into a nightmare of old age? The value of money has altered in his life time. Inflation eats into the value of money.

If we need Rs.10,000 for our monthly expense today, we will need a far higher amount, given inflation, when we retire at a future date. If it costs Rs.2 lakh to secure education for our children today, it will cost far more in the future. Inflation alters the value of money over time, and this understanding is critical when we make our investment decisions. We have to plan for the future value of money and not be satisfied with what we currently have.

If the value of money keeps changing, there is a beneficial way of looking at it as well. If an investment grows at 10%, and we allow not just the principal, but also the interest income, to grow, we are likely to get a bigger benefit over a long term. We call this the benefit of compounding. Assume we invested Rs.1800 every year and earned 10% return on it. Over a period of 20 years, our income would be Rs.3600 (180 per year for 20 years). But if we did not pull out the return, but allowed it to grow, the amount we will have at the end of 20 years would be about Rs.12,000. This is time value of money working in our favour. Money multiplies over time and grows into a larger sum if left to compound. When we make an investment decision, there are two factors at work. Inflation erodes the value of money; compounded returns enhance the value of money. The final value of the investment will beat inflation, only if the compounding rate of return is higher than the inflation rate. Return is like moving two step forward, and inflation is like moving one step backward. If we choose investments that grow at a rate higher than inflation, we will beat the erosion that inflation will cause to our wealth and well being. We can use this insight when we plan for future goals like education and retirement. This is why equity is a critical component of every long term investment plan. Return from equity investment has been known to beat inflation rates over the long term. Equity funds enable our money to grow to a larger sum, when we most need it. The portfolios of children education plans, retirement plans and long term funds have an equity component, to give us the benefit of being able to beat inflation over time. Funds offer investors a reinvestment and growth option, to ensure we get the benefits of compounding. Knowing that money has time value helps us understand that we can save and invest wisely over long periods of time, to plan for our long term goals better. We can set money aside today, so when we speak to our grandchildren about our times, our stories carry nostalgia, but no regret.

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