THE DIFFICULTY OF MARKET TIMING

THE LONGER YOU STAY INVESTED IN A GOOD BUSINESS, THE MORE IT WILL GROW AND REWARD YOU WITH HIGHER PROFITS

The investor community would largely agree to the fact that equities have the potential to deliver the highest returns among various asset classes. However, in reality, most investors do not benefit from the long term compounding ability of equities. Some of them stay away from it due to the volatile nature of the share market, while others try to time their entry into and exit from the equity markets; in the process, they end up making losses. The only way to overcome these issues, is to remain invested in equities with a long-term view, and the best way to do this is to invest in equity mutual funds since they are managed by experts in professional fund houses.

A LONG-TERM VIEW

In the long term, i.e. five years or more, the market rewards investors with multiple benefits. First, it helps investors to overcome short-term volatility — a situation that occurs because prices of shares change almost every second: they get influenced by news reports about the company; or any information about the sectors in which that company operates, and also from the domestic and global macroeconomic situation. However, in the long term, fundamentally strong companies manage to survive and grow their business in all environments.

Therefore, the longer you stay invested in equities/equity mutual funds, the higher will be your gain.

A SHORT-TERM VIEW

In the short term, market participants typically over-react to information flows and this leads to high volatility in stock markets. Such a situation arose post 9/11 when the equity markets worldwide tanked. However, in the medium- to long-term period, sanity prevails and volatility is lesser. Hence, in order to protect your money from falling victim to short-term volatility, you should invest in equity mutual funds with a minimum five-year time frame. You can take a staggered approach while selling too, so that you don't sell all your equity investments on a particular day and get exposed to that day's market condition.

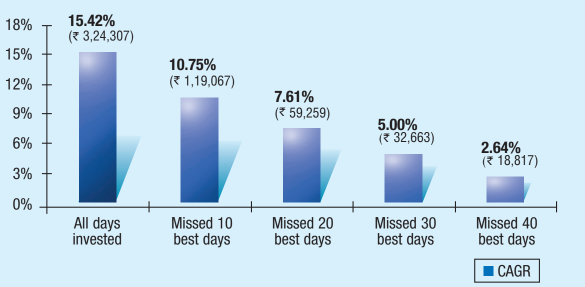
DON'T TIME THE MARKET

Don't succumb to the temptation of timing the market. You may want to buy shares/equity funds at a lower price and sell them at a higher price, but in the process, you may miss the best days in the market. As the chart *Stay Invested for the Long Term* shows, if you had invested ₹ 10,000 on April 2, 1990, and remained invested for all days till June 30, 2014, you would have accumulated ₹ 3,24,307 which translates to a return of 15.42%. However, if you had the missed the 10 best days, you would have accumulated ₹ 1,19,067 i.e. 10.75% only.

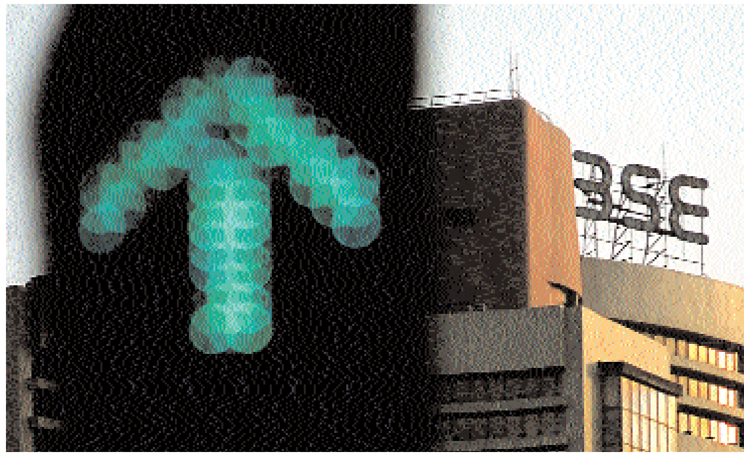
The reality is no one can predict the best and worst days in the equity market. A prudent investor is one who remains invested and allows his money to compound.

STAY INVESTED FOR THE LONG TERM

What do you do when you feel the market is about to decline? Do you withdraw your money and wait till you feel stocks have bottomed out? The chart below shows that if you had stayed fully invested in stocks (as measured by the S&P BSE Sensex) from April 2, 1990 to June 30, 2014, you would have earned compounded annual returns of 15.42%. However, if you had tried to time the ups and downs of the market, you would have risked missing out on days that registered some of the biggest gains. The more good days you missed, the lower the returns you would have achieved. For e.g., if you had invested ₹ 10,000 on April 2, 1990, it would have compounded to ₹ 3,24,307 on June 30, 2014. Given below are the returns you would have earned if you had timed the market during this period.



Daily returns from April 2,1990 to June 30, 2014
Source: Internal calculations based on data procured from www.bseindia.com



POWER OF COMPOUNDING

AGE:	25 years
SIP:	Rs 2000 per month
PERIOD:	35 years
PRINCIPAL INVESTED:	8.4 lakh
CORPUS AT 60 YEARS*:	Rs 1.09 crore
AGE:	35 years
SIP:	Rs 4,000 per month
PERIOD:	25 years
PRINCIPAL INVESTED:	Rs 12 lakh
CORPUS AT 60 YEARS*:	Rs 67.46 lakh
AGE:	45 years
SIP:	Rs 8,000 per month
PERIOD:	15 years
PRINCIPAL INVESTED:	Rs 14.4 lakh
CORPUS AT 60 YEARS*:	Rs 37.72 lakh

*Assumed rate of return: 12%

GAIN FROM THE POWER OF COMPOUNDING

THROUGH COMPOUNDING, YOU CAN REAP GREATER RETURNS BECAUSE IT TRANSFORMS YOUR INVESTMENTS INTO AN EFFECTIVE INCOME-GENERATING ASSET

You must have heard this *ad nauseam* that disciplined investing and a long-term perspective hold rich rewards for the patient investor. Not convinced? Well, try answering this riddle — if a person saves ₹ 5,000 a month in an investment that earns 12% per year, his corpus at the end of 30 years will be ₹ 1.52 crore. Now, if he wants to change his plan and has three options before him, in which of them will his corpus be the lowest?

- A He chooses an option that earns 9% annualised returns.
- B He reduces investment to ₹ 3,000 a month.
- C He reduces the tenure to 25 years.

The correct answer is C, wherein his corpus would be ₹ 84.33 lakh compared to ₹ 84.95 lakh with option A and ₹ 91.58 lakh with option B. Observe that reducing the returns by 3 percentage points or the investment amount by 40% did not have as much a bearing on the final amount as the reduction of the tenure from 30 to 25 years.

Compounding is a disciplined investor's best friend. Through this technique, you can reap greater returns because it transforms your investments into an effective income-generating asset. The basic premise behind this concept is that over a period of time, earnings from investments that are not spent but reinvested, can generate greater returns.

Compounding interest is critical to investment growth because it is paying interest on interest as compared to simple interest which earns interest off the principal. In other words, with compound interest your initial investment is continually reinvesting itself!

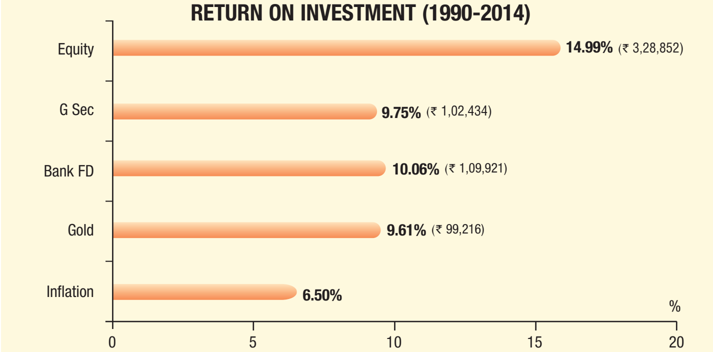
The last five years are crucial for the power of compounding. The gains from compounding are initially modest but they gather strength as the years pass. The longer the money stays invested, the faster it grows. As the graphic *Power of Compounding* shows, a 25-year-old person saving a modest ₹ 2,000 will have a corpus three times bigger than someone who starts saving four times as much at age 45!

Many young investors keep procrastinating over their investment plans without realising that with each passing year, they are foregoing the opportunity to benefit from the extraordinary power of compounding. The best way to ensure financial nirvana is to start saving today. Remember, the amount you can save is not as important as getting started early.

Another factor that influences your kitty size in the long term is the rate of return you get. Though that may not be under your control, it is natural for any investor to aim for the highest possible return on investment. That is possible only with equity investments held with a long-term view. Equity mutual funds help you towards the same. According to data received from CLSA, during the period April 3, 1989-March 31, 2014, equities have delivered 14.99% compounded annual rate of return as compared to 10.06% offered by bank fixed deposits. Investments in gold and government bonds lag behind and offered returns of 9.61% and 9.75% respectively. That means if you had invested ₹ 10,000 on April 3, 1989, you would have accumulated ₹ 3,28,852 on March 31, 2014 through your equity investments, but only ₹ 1,09,921 (10.06%) from your bank FDs. Since long-term capital gains on equities do not attract any tax, the returns from equities would have been the highest.

Remember, equity investments not only offer you higher returns as compared to other asset classes, but also help to beat inflation by a wide margin over the long term. This makes it a strong portfolio candidate to build a big corpus.

RETURN ON INVESTMENT (1990-2014)



Source: CLSA. Data from RBI and Bloomberg for the period April 3, 1989 to March 31, 2014.
+ The amount mentioned reflects the value on March 31, 2014 of ₹ 10,000 invested on April 3, 1989.
Note: The features and risk profile of each instrument / its underlying assets are different. Hence, there would be difference in the returns. However, the purpose of comparison is mainly to show that despite the risk and volatility in the short term, over long term, equity as an asset class outperforms others in providing inflation adjusted returns.

WHAT IS THE RULE OF 72?

The Rule of 72 is a rule of thumb (credited to Albert Einstein) that investors use to approximate the time it takes for money to double at a given rate of return. It states that if you divide the number 72 by any given rate of return, the answer you get is the time it takes for money to double at that given interest rate (assuming you can get the same rate each year and it is compounded annually). For example, if you earn 10% on your money, it would double in 7.2 years (72 divided by 10 = 7.2).

It is essential to take into consideration the inflation factor which determines the real rate of return on investments. Remember, the Rule of 72 is a mathematical concept, and the hypothetical return illustrated is not representative of a specific investment.