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How to Prepare Investing Roadmap

TIPBlog.in

e-Guide Book

How to Prepare Investing Roadmap

By

TIPBlog.in

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Preface

Let me begin with a question. When you downloaded this e-guide, what was your expectation? Take a pause, think for a moment, and phrase your response. After you are done you may continue to read this e-guide.

One of my foremost principles of writing on my blog, TIPBlog.in, is that I have utmost respect for intelligence of my readers. I value the time spent by readers on my blog. I do not publish any post on my blog if I believe I cannot add any value to a given discussion. If you have been visiting my blog, you must have realized I try not to focus on re-publication or re-hashing or rewording already published news or stories. Internet and blog-o-sphere has many valuable resources that provide stock advice, stock tips, personal finance guides, tax consultations, advice on mutual funds, corporate news, etc. Many of my fellow bloggers….. Keeping with that thought process, I expect that this text will add value to your thought process; it will force you to think differently from the herd.

The purpose of this text is to share with you how to develop your own investing roadmap. This method or process is not based on any hypothetical principles or out of any academic books. To put it in simple terms, it is a documentation of my own investment journey.

I have been using this process for last 10 years and hence, have learnt quite a bit of my own lessons. It has worked for me in past, it is working for me in present, and I am confident it will continue to work in future. This e-guide will show you how simple it is to prepare a roadmap for yourself. It will also show you how I used this and prepared my own roadmap.

Finally, let me be very clear, I am not attempting to sell you anything. Access to my blog and every article, analysis, and my comments on any subject are completely free. They will remain free for you to enjoy. The best way you can pay me back for my efforts is to help in the discussions on my blog, leave comments, and express your viewpoints. There is never a dumb question and there is never a dumb argument. I would happy to listen to you and understand your viewpoint. You may also present your critic about this text. Different ways to send your views across to me are:

1. Email: income.portfolio@gmail.com
2. Use contact page on TIPBlog.in at http://www.tipblog.in/contact/
3. Leave your message at http://www.tipblog.in/ebook/

I hope by the end of this e-guide you will understand what it takes to prepare your own personal investing roadmap.

In few days you can make good acquaintances, but friendship takes a long time to build.
Similarly, you may earn few bucks in trades, but it takes a long time to build wealth

Introduction

In its simplest terms, preparing investing roadmap is a practice of dividing your financial resources among different types of assets such as savings, certificate of deposits, liquid cash, bonds, stocks, mutual funds, investment partnerships, real estate, and private equity. The notion is that individual investors can reduce risk because each asset class has a different correlation to the others, e.g. when stock markets rise, more often bonds get reduced. At a time when the stock market begins to fall, real estate rental income may still continue to provide cash flow and returns.

The actual amount an investor puts in each asset class is determined by individual's asset allocation model. Such asset allocation models should be designed such that it reflects individual's personal goals, needs, time frame, and risk tolerance.

This e-book is organized sequentially in three parts. Part I focuses on understanding investor's characteristics and requirements. It shows how to determine investor's risk profile in three different dimensions. It shows how to identify the goals for investments. Part II focuses on formulating investing strategy and what different type of assets can be used. Finally, the Part III of this text focuses on execution and continuous monitoring.

This text is designed to be read in sequence, and it is suggested that readers do not skip any part. This e-book is a progressive step-by-step approach. My expectation is that by the end of the e-book, individuals should be able to identify a roadmap for themselves.

Part I

Know your Investment Characteristics
And
Requirements

Risk Profile

Investors need to understand their risk profile in order to be a successful wealth accumulator and sustain it over a long period of time. Investors need to map out personal risk and then decide their goals. Trying to determine our own investment risk profile is very subjective process. This is because of personal bias creeps into our analysis, our natural tendency to be perennially optimistic, and biasing due to business media projections. In the media hype, and he said, she said scenarios; we tend to forget the realistic scenarios that are applicable to us alone.

I believe that risk profiling is very much individualistic (i.e. one individual or one family). Every individual will have a unique risk definition. It is possible that qualitatively, the risk profile could be classified in similar groups. However, quantitatively it would be different for each individual.

When I started investing eight or nine years ago, I was bombarded with the advice that I should invest according to my risk appetite. Everybody had a piece of advice for me, my dad, my friends, my broker, my tax filing guy, personal finance advisor at work place, etc, Being a numbers fanatic, *I always kept wondering, what is risk appetite*? How do you determine what is personal risk appetite? To my surprise it was an alien question for everyone. Whenever I asked this question to my so called expert advisor, almost everybody use to start blabbering with ifs and buts. Therefore, for me, it was learning by experience. Over last few years, I have come with a way of defining my risk profile and invest accordingly.

My approach of defining a risk profile consists of mapping it into three different dimensions. These three dimensions of risks are (1) Time; (2) Capacity; and (3) Tolerance.

1. **Time** is associated with individual's financial needs and what one wants to achieve in short-term, intermediate-term, and long-term.

2. **Capacity** is how much one can afford and how much one can stretch in their investments. This is an actual Rupee amount. e.g. Do you have 10 lakh rupees for investments, or do you have only 10 thousand rupees to invest, or do you have only 100 rupees at regular intervals.

3. **Tolerance** is how much volatility in our investments we can afford. This could be percentage based or actual rupee amount.

Table 1 below shows mapping of this risk matrix. As we go along with guide, I will fill this matrix using an example.

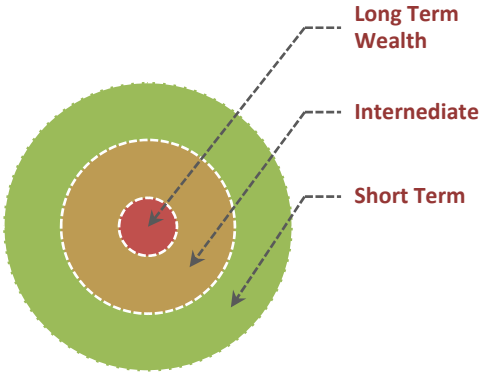
Table 1: Mapping Risk in Three Different Dimensions

Time Frame	Capacity	Tolerance
Short Term (2 years)		
Intermediate Term (2 to 5 years)		
Long Term (5 years of more, preferably 10+ years)		

The essence of this matrix is that it captures our immediate needs; it provides us a certain level of visibility in near future and/or in longer term. This matrix shows the parameters that we can use for preparing our roadmap. It gives a tangible framework for any individual's roadmap. The next step is to fill this matrix with some actual information that includes some numbers and data.

Investment Goals – WHAT do we need and WHEN

Before we start investing, we need to identify a finishing line. Otherwise we will keep running around not knowing where the end line is. In this step of our road mapping process, we need to identify a vision for ourselves. We need to ask ourselves, what we want to achieve from our investments. We need to make sure that our goals are realistic, but not very simple to achieve. The goals should be achievable but it should require sustained level of effort over a period of time. It should not be simple otherwise we will fall short e.g. I can run one kilometer race, but what's the point if you do it in one whole day. I know you want to become the Tata's, the Birla's, the Ambani's, and the Bill Gates of the world. However, let's be realistic and make sure that we don't start day dreaming. It will not lead you anywhere, except frustration.



The best way to address this is start filling-in the matrix that we prepared in risk profiling step. In financial terms, what do we want to

achieve in short term, intermediate term, and long term. As an illustration, I will use examples from my own personal experience.

Short Term

My viewpoint is short term time period should be considered as immediate two years. When I decide my short term goal, I think about my expected expenses such as (1) buying new transportation vehicle; (2) repair and maintenance of my existing vehicles, (3) cash reserve for six month worth of living expenses; and (5) buffer for any other event like vacation, festival expenses, marriages, etc. Here, you have to identify a projected rupee amount (i.e. capacity) for which you will have zero tolerance.

Intermediate Term

Intermediate-term should be considered as next 2-5 years. You should project your expenses and family's state-of-finance. When I review my needs for intermediate term, I think about (1) down payment of house; (2) impending marriages; (3) college tuitions; (4) medical expenses, if any; (5) buying vehicles; etc. I am willing to allocate a certain rupee amount that can tolerate some level of fluctuations. Since the timeframe is 2 to 5 years, I was willing to accept 15% to 20% negative variations. i.e. it is acceptable to me if my Rs. 2,00,000 amount reduces to Rs. 1,60,000.

Long Term

In long-term, i.e. 10 years and beyond, my focus is to build wealth. I can afford to ignore market fluctuations because I do not depend upon these investments to meet my day-to-day living expenses. Therefore, I am willing to allocate capital that can take higher

fluctuations. Longer timeline builds-in wider tolerance, because I do not have any immediate need to access this capital. I will not be forced to liquid (or sell) my positions.

As an example, I filled up the matrix below in Table 2. It gives the map of how much I would need and when I would need.

Table 2: Completing Filling up Matrix

Time Frame	Capacity	Tolerance
Short Term (2 years)	• 15% of my wealth • I need to keep this amount in liquid cash to meet my needs in two years.	• Zero Tolerance • Cannot loose value of this capital
Intermediate Term (2 to 5 years)	• 15% of my wealth	• 15% to 20% negative variation is acceptable
Long Term (5 years of more, preferably 10+ years)	• Monthly, I will allocate 20% of my salary income to these investments	• High amount of variability is acceptable. • I do not need this capital for another 10 years.

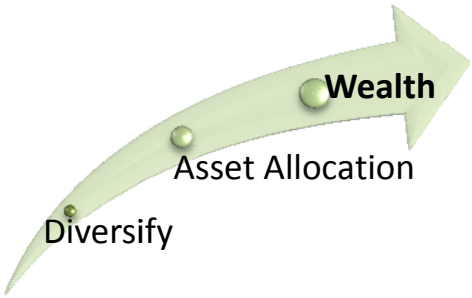
NOTE: In capacity column, I have included only percentages. But I recommend that every individual should use actual rupee amount (and not percentages).

So far we have identified our risk-based time bound financial needs. We have identified WHEN/WHAT we need financial resources. Next step is to determine, HOW to get there and WHAT vehicle to use to get there?


Two
Tools
Part II
Investment
Strategy
Buying
Asset
Class
Mapping

Asset Allocation and Diversification – Two Tools

Any investor investing for long term (i.e. 10+ years) must use the principles of asset allocation and diversification in their portfolio management process. These are two aspects that help investors manage risk of their wealth or investments. Both asset allocation and diversification are two different aspects and hence they have different objectives. The primary reason individual investors get exposed to downside risk is because many are unable to differentiate between asset allocation and diversification.



Asset allocation is a strategy of allocating capital (or your money) to different types of assets which are not correlated (or at least have low correlation). The notion here is that, over time, the volatility in returns will smooth out if they have low correlations. The different types of assets that I am discussing here include cash, government bonds, corporation bonds, common stocks, preferred stocks, real estate, private equity, natural resources, commodities, partnerships, etc.

In general, many studies in different markets of the world have shown that there is *low correlation between stocks, bonds, real estate, and natural resources*.

Furthermore, many studies have also shown that there is relatively *higher correlation between style of investing* (i.e. growth, value, blend) and *market capitalization* (i.e. small cap, mid cap, large cap). These

correlations range from 0.7 to 0.96 (1.0 being perfect correlation and 0.0 being no correlation).

What this means is; if a long term investor invests in companies with different market capitalization, even then, the investor is not getting any asset allocation benefits. The investor is likely getting diversification benefits only. Diversification helps manage risk from the view of sectors, industry, and investing style alone. This does not provide asset allocation benefits.

The issue with diversification is such that it not easy to truly understand how to execute diversification. There is no simple straight forward method to design a portfolio which has high diversification. Investors blindly assume that investing in different sectors, industries, companies, etc, will provide diversification. That is misconception which exposes them to downside risk.

Asset allocation and diversification are tools for portfolio risk management. However, both have different approaches and implemented in different ways. It is unlikely that a beginner, or new investor, will have invested in all different assets. But it can be built over time depending upon individual's risk profile.

It can be argued that all these discussions of asset allocation and diversification can be tossed out based on what's happened in 2008 and continuing in 2009. However, investor's need to realize that investing is a long term process. The two or three years is a very small time period and does not reflect the true benefits of the asset allocation and

diversification. In addition, portfolios that are based on these two principles would have had less downside risk.

Now that we understand two basic principles, the next step is to list different assets and available investment vehicles.

Asset Classes and Investment Vehicles

Table 3 below shows different types of asset classes and corresponding investment vehicles that are widely used by individual investors. This may not be comprehensive list, but it gives an overview of different asset classes.

Table 3: Asset Class and Corresponding Investment Vehicles

Asset Class **Provides benefits of asset allocation**	**Investment Vehicles** **Provides benefits of diversification**
Savings, and Certificate of Deposits	• Low interest bearing bank accounts • Higher interest bearing certificates
Bonds	• Government bonds/certificates • Public company bonds • Private company bonds
Real Estate (and its derivatives)	• Owning your own house • Rental property • Investing in construction projects • Owning stock in housing construction company
Commodities (and its derivatives)	• Owning a gold jewelry • Owning gold coins • Investing in commodity futures traded on stock markets
Publicly Traded Equities	• Common shares (or stocks)

	• Preferential shares • Convertible debentures • Mutual funds • Exchange trades funds
Insurances	• And its derivates and different types
Collectibles	• Old gold coins • Paintings • Old cars • Memorabilia signed by famous personalities
Private Equity	• Angel Investing • Venture Capital Investing • Partnerships

Each asset class listed in table above has (1) its own characteristics; and (2) used for specific purpose. You cannot blindly invest hoping that it will increase your wealth. As an individual investor, it is not required to invest in all of them. Investors need to understand pros and cons of each asset class, and then pick those that meet your objectives. Let us take few examples.

Example 1: Owning a house

Many folks view this as an investment, and still many view this as part of their wealth. The way I look at this is, if I live in my house, it is not an investment or it is not my wealth. If I am living in my house, it is taking care of my daily needs. Even if I did not own a house, I would need a place to live. I would need to pay rent. So I view this as part of my living requirements. Just like money spent of food is not an investment, similarly, money going into housing should not be viewed as an investment.

My view of owning house is that it is an expense as long as you are paying installments for the house you are living in. After you complete the payout in full for your house, it will provide you with more disposable money in future. You may use your future expected money for other expenses or other investments.

It is argued that it always increases in value. It is correct that it increases in value. But think over it. If the value of your house increases, what does it really mean? If you want to live at another location with same standard, you will probably spend same amount of money to buy the new place. Does that extra wealth (or increased value) give you anything?

Having said that I still believe buying a house is best way to utilize your present money. Owning house has two advantages viz. (1) the rental amount that you pay to landlord is lost forever. It does not help you reduce your future expenses; and (2) Owing a house is very good hedge for value of your money. Buying a house on loan and increasing your equity every year is good to maintain the value of your money.

Owing a house and living in it, does not increase your wealth. It indirectly helps you reduces your future living expenses. Furthermore, there are other intangible benefits of owning a house like sense of ownership, peaceful sleep, a roof to live, etc.

On the other hand, owing a house with rental income, or flipping in short time can be considered as an investment.

Example 2: Savings and CDs are risk free

Quite contrarily, they are not risk free. This asset class has high inflation risk. The interest that these asset class pays, barely keeps up with the real inflation that common man sees on the streets. I am not comparing this with government published inflation rates which are based on wholesale price index.

Mapping Asset Class for Personal Investments

So far, we have identified a goal, and formulated a high level risk based investing framework, and we also know investment vehicles. The next step is to determine how we are going to execute it.

We will not go ahead and see how we can expand our matrix to include asset classes. Table 5 below shows the mapping of assets into our matrix.

Table 5: Expanding the Matrix by Mapping Asset Class

Time Frame	Capacity	Tolerance	Asset Class
Short Term (2 years)	• 15% of my wealth • I need to keep this amount in liquid cash to meet my needs in two years.	• Zero Tolerance • Cannot loose value of this capital	• Savings • CDs • Bonds
Intermediate Term (2 to 5 years)	• 15% of my wealth	• 15% to 20% negative variation is	• Bonds • Equities (exchange traded funds)

Time Frame	Capacity	Tolerance	Asset Class
		acceptable	• Ongoing Rental Property investment • Construction Projects • Commodities (Jewelry)
Long Term (preferably 10+ years)	• Monthly, I will allocate 20% of my salary income to these investments	• High amount of variability is acceptable. • I do not need this capital for another 10 years.	• Owning a house • Commodity • Private equity • Jewelry • Public traded equities (common shares only) • Start of investments in Rental Property • Insurance

Note: These are examples. Items in blue are the ones I use for my asset allocation.

Guiding Principles and Rules for Execution

Once we identify our investment goals, the next step is to come up with few guiding principles and rules for executing this roadmap. We must formulate our guidelines such that we are able follow it and strictly abide by it at all times. There should be no "chalta hai" attitude. The moment we bring in "chalta hai" then rest assured, you are setting your self for failure.

- We must review your status quarterly and yearly.
- If we empty or lower our short term or intermediate term assets, you will replenish it before allocating it to long term assets.

- Any single position should not be more than 5% of you total overall assets.

  e.g. A single bank savings account should have less than 5% of your total portfolio (or wealth). Same goes with CDs at one particular bank. If you want to keep large amount of cash, it is preferred to keep at least in two different savings accounts.

- Short-term and intermediate-term:

  No single investment in one bank, or one CD, or one savings account, or single fashioned jewelry. Have at least two or three different accounts, each in different banks.

- Long term:

  No single stock should be more than 3% of our total assets.

Discipline is the first step on the ladder of success.

- Buy only at discount – do not buy at historically high levels.
- Investing is long term process. Do not react on media news and sky-is-falling scenarios, and market chatter. Those folks are paid to comments and it is their job to comment. If they don't they will not get their salary.
- Be patience and remember that "slow and steady wins the race".
- Don't be penny wise and pound foolish.

Investment Buying Process

In my discussions with many bloggers, friends, and family members, I have observed that lot of us face the issue of, when buying for first time, how much should we be investing in any given vehicle. There are few

different schools of thought on this issue. In my view, each of the thoughts, methods, and approach is valid depending upon investor's objective.

One thought says buy at once in one go, because if one has spent time following it, researching it, then why wait for other occasions. The fact that an investor has questions (or doubt), that means this individual has doubts, or is not confident about it. One is questioning own analysis. It could be lack of proper understanding of the investment vehicle or asset or lack of research.

- In my view, this approach is suited for investor's who understand opportunity and are willing to take higher risk.

Another thought says, to use cost averaging over a period of time. Here, investors use an *automatic systematic fixed investment amount*, at fixed frequency, and over a fixed period of time. For example, an investor withdraws a fixed Rs. 2000 from his checking/savings account and invests it every month continuously for one year or more. In this process the key aspect is, there is no thought process involved. After the investment vehicle is selected, there is no thinking or analysis involved. It is purely mechanical. The advantage is that one does not need to worry for investing every month and a systematic process is being set for his investments. It allows smaller amounts for investments. In many investing vehicles (e.g. mutual funds), the investing/transaction cost can be controlled.

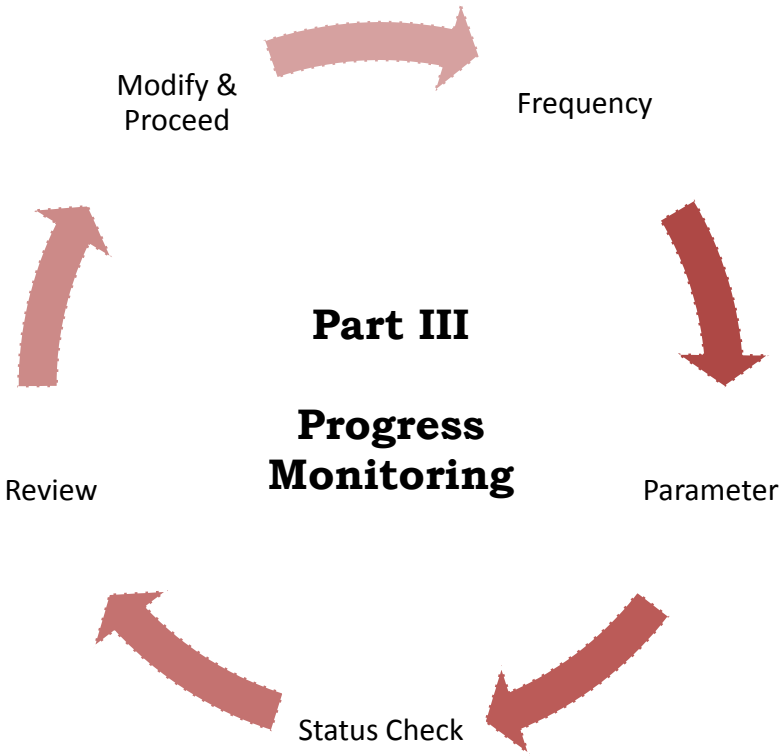
Buying Price Determines Your Profit

- I believe this approach is best suited for fixed income vehicles like CDs, fixed bonds, government guaranteed certificates, etc. Here one knows the fixed value and need not worry about price fluctuations.

Still another thought says, to buy in blocks of one half (50%), and/or one third (33%), and/or one fourth (25%). This is different than cost averaging, in a sense that, it involves continuous evaluations. If an investment vehicle is performing well, then one may add to existing position. If it is doing badly, then one may limit exposure. Furthermore, there is flexibility in time frame and actual amount for addition. It can be few months or few years.

- This approach is more suited for investors who want to buy rental property, construction projects, stocks for long term, etc. Here an investor wants to remain associated for a longer time period.

On a personal front: I use fixed systematic investments in CDs, fixed bonds, and government certificates. All these also act as safe and non volatile investments. For my long term portfolio, I buy stocks that I want to invest for long term and grow with the company. I buy stocks in blocks of one third over a period of time. I initiate a position which helps me follow the company. It also helps me make sure; I am not making a mistake. It may take me one year, two years, or more for second or third installments.


Modify &
Proceed
Frequency
Part III
Progress
Monitoring
Review
Parameter
Status Check

Monitor Progress

Any investment roadmap or process must have continuous progress monitoring. There are two aspects that are associated with monitoring progress viz., (1) Monitoring frequency; and (2) Monitoring parameters.

Monitoring frequency: You should identify for yourself what is the right time period for reviewing your progress. I suggest that monitoring should be done on quarterly-basis and/or yearly-basis.

Monitoring parameters: You should identify what you are going to measure on quarterly basis and what you will measure on yearly basis. In the context of our matrix example, let's walk through it ……

Short Term

Your asset classes are savings, CDs, and bonds. These do not change values in a quarter or in a year. They will add fixed percentage to the principle. For short term, the progress monitoring should be for "value against your target", or "capacity against your needs".

- Is it consistent with your target?
- Does it require replenishment?
- Does it require renewals?
- Do you expect any new event that requires short term increase?

Intermediate Term

Asset classes in this part are the ones that require more attention in quarterly progress reviews. Some of the areas that require attention are:

- What has been the change in value?
- What has been the progress of ETF or funds?

- Does it require replenishment?
- Does it require reallocation?
- Are construction projects or rental income making progress?
- Any new installments are due?

Longer Term

Asset classes in this part require more attention in yearly progress reviews. A yearly status check should be done for:

- Reviewing allocation levels against your target;
- Reviewing which assets are performing, does it require reduction?
- Reviewing which assets are underperforming;
- Review for any fundamental changes? Does it require selling?
- Looking at change in value and making emotional decision should never be done. Remember your risk is managed by your asset allocation.

Patience is second step on the ladder of success

Many time folks argue that if you do not react, you may loose everything. They site Satyam as an example. This though process completely wrong. If you are following the risk based investment process, then (1) you would not invest more than 3% in any position; and (2) you would have not bought it at high value. In this way, you have already built-in safeguards. If you didn't follow risk based allocation, then any amount of action and reaction will not save you from failure.

In Summary…

Sensible and prudent investing is an easy way to build your long term sustainable wealth. One does not need to spend enormous amount of time for investing. We spend 8 hours a day working to earn that salary; can't we spend at least 10% of that time to manage those earnings?

It is a very simple process. We individuals make it complex.

My viewpoint about additional resources on the Web

You will find marketing and sales brochures all over the place that mimic as a helpful guide. However, those are usually attempting to sell their product by making it look good.

One pitfall and time waste is the reading out NIFTY or BSE analysis. There are many web resources that comment about index analysis or movements, but they do not discuss about index funds or ETFs. How is market index analysis related to individual stock investing? You analyze index if you want to invest in index funds.

Second pitfall is spending time on web resources or blogs which provide you the same information or folks who themselves to do not follow their own advice, but purport the ideas calming to be spreading free information.

The best place to learn about personal finance or investing is to read articles and blogs where authors are sharing their personal experiences. What I mean by personal experiences is; their story about investing in a particular way, their thought process why something works for them and something doesn't work for them, where they put media hype in proper perspectives, where authors are ready to accept mistakes, and are willing to learn with you.

Additional Worksheet

Time Frame	Capacity	Tolerance	Asset Class
Short Term (2 years)			• Savings • CDs • Bonds
Intermediate Term (2 to 5 years)			• Bonds • Equities (exchange traded funds) • Ongoing Rental Property investment • Construction Projects • Commodities (Jewelry)
Long Term (preferably 10+ years)			• Owning a house • Commodity • Private equity • Jewelry • Public traded equities (common shares only) • Start of investments in Rental Property • Insurance