Inflation: Ek Villain

Summary: *Inflation is the general rise in the cost of expenses due to the change in the money supply or the availability of goods. The Consumer Price Index is the most known measure of inflation which measures changes in price level of consumer goods and services. As inflation has a bearing on your goals, this is an important factor to be considered while planning for your goals. Investing in equity mutual funds through the SIP route over the long term helps in getting good returns.*

What is Inflation?

Inflation is the general rise in the cost of expenses due to the change in the money supply or the availability of goods. For instance, you can buy 1 litre of milk for Rs.60 today. The same quantity of milk would have cost you Rs.40 ten years ago. And 10 years from now, you might have to pay Rs.80 for the same milk. This means that your buying power to purchase something reduces due to increase in cost of goods. This increase in cost is termed as inflation.

How does inflation affect you?

The Consumer Price Index is the most known measure of inflation which measures changes in price level of consumer goods and services. Typically medical costs, education costs, transportation costs have risen at a double-digit rate. Over the years, inflation eats out your purchasing power as the price level of goods keeps on increasing. Inflation has an effect on all your goals in life and therefore, it is of utmost important to consider it while preparing your financial plan.

Case: Mrs.Seth has a 8-year old son. She wishes to send him to Australia for Post Graduation when he turns 21. The estimated present cost of this education is Rs.25 lakh. Assuming inflation of 7% p.a., Mrs.Seth needs to accumulate Rs.60 lakh at the end of 13 years from now in order to meet for education expenses. If the inflation is increased from 7% to 10% p.a. then she needs a corpus of Rs.86 lakh. This is the impact inflation has on the future goals.

It is obvious that inflation is the primary factor important in planning for goals, so one can estimate the future rate of inflation by looking at the past history and current economic scenarios.

What should be the choice of investments?

It is important to invest in instruments which give you higher post-tax and inflation returns. For instance you have Rs.1 lakh and you want to invest it for 15 years. Considering inflation of 10% p.a. the future value of your investment will be Rs.4.17 lakhs. Hence to maintain the purchasing power of Rs.1 lakh you will have to invest in asset class which will fetch you 10% return or even more than that. Let's have a look at different avenues:

1) If you maintain Rs.1 lakh in Savings Bank Account assuming 4% p.a. you will be able to accumulate Rs.1.8 lakhs at the end of 15 years.

2) If you invest in Fixed Deposit for 15 years at 8% post-tax return, you have Rs.3.17 lakhs.

3) If you invest the same amount in equity mutual funds for 15 years at 12.6% post-tax return you will be able to build a corpus of Rs.5.93 lakhs.

From the above scenarios it is clear that equity mutual fund portfolio fetches you return more than inflation and also safeguards the purchasing power of your investment. However, it is always recommended to invest in equity mutual funds through a Systematic Investment Plan, to help counter market volatility.

Stocks, Mutual Funds and Equity related investments are the best avenues to fight inflation over the long term. These products are risky asset class but over the long term they can help you earn higher return than inflation and accumulate your corpus for the goals. Also you should not have all your eggs in one basket; it calls for diversifying your investment in different asset classes in order to reduce risk, while aiming for high returns.