The Building Blocks of Financial Planning

Just like a building where you start with the foundation and then move upwards towards the first floor, second floor and so on, the financial planning building has five blocks to scale. The first two blocks are the foundations and then the next three levels where you actually experience the benefits of a strong foundation.

Let us have a look at these blocks, what they are and how to go about their planning:

4. Retirement planning
3. Investment planning
2. Insurance planning
1. Contingency planning

One might be wondering why the reverse order? Just as mentioned we have to build the foundation and then move upwards. The foundation starts with contingency planning and then you gradually move up.

The first two blocks: contingency planning and insurance planning is known as risk management. Also, in a layman's term, it is the foundation of a good financial planning. Once this is in place, you are not worried as it takes care of all your emergency situations (contingency planning) as well as your insurance requirements (that is your health insurance, life insurance and other insurance).

Once your risk is managed, you can then safely move on to the higher levels to plan for your goals. The next two levels are investment planning and retirement planning collectively known as goal planning.

Let us start with the foundation and the first of the two levels in risk management.

Contingency planning

Also known as emergency planning. It has been emphasised time and again that a contingency plan or an emergency plan has to be in place before starting to plan for other goals. Why? Emergencies can come anytime or anyplace especially when we least expect it. We cannot predict it or even prevent it but what we can do is buffer ourselves against it so that our life does not go for a toss due to the emergency. It is basically saving for a rainy day. So once that you have planned for any untoward or unpredicted eventualities, you can safely move ahead to the next level of the financial plan.

How to calculate?

All your mandatory monthly expenses which you have to meet by hook or by crook have to be taken into account. A list of all mandatory expenses has been given below:

Fixed mandatory expenses (which are fixed every month) include:

- Mortgage instalment
- Car loan instalment
- Other loan instalments
- Life insurance premium
- Health insurance premium

And variable mandatory expenses (which are mandatory but vary every month) include:

- Food
- Utilities
- Grocery
- Transportation
- Miscellaneous (unavoidable) expenses

The above expenses have to be calculated on a yearly basis and then divided by 12 months so as to arrive at an average monthly figure.

How much to set aside?

At least three months of your average monthly expenses have to be kept aside in the form of emergency funds since it is generally observed that three months' worth of funds are enough to meet most emergencies and come back on track. People nearing retirement should try and keep aside at least five to six months of mandatory monthly expenses as contingency fund.

Let us take an example: Say your yearly mandatory expense is Rs.350,000.00. Hence your monthly average expenses will come to Rs.29,167 (3,50,000/12) (rounded off). You need to keep aside Rs.87,500 (29,167*3) that is your three months' average monthly expenses as contingency funds to meet any eventualities.

It is not necessary to keep the entire amount in cash. You can keep aside Rs 20,000 in cash and the balance you can split between savings account, fixed deposit, or liquid funds. Why? Because all of the above-mentioned products have liquidity, their biggest advantage, which is a very important feature in case of any emergencies. Also, remember that in case of usage of these funds always remember to replenish it.

Insurance planning

It is the planning for an adequate amount of insurance. And it definitely does not end with life insurance alone. One needs to also plan for health insurance, disability insurance, and property insurance. These insurances are very important and everyone should try to incorporate them in their insurance planning. First and foremost, it is very important to know one very important fact. Insurance is not investment and vice versa. Never try to mix the two. Insurance is for risk management and investments are for goal achievements. This golden rule should form the crux of your decision-making when buying insurance policies. Never buy insurance just because someone advises you to buy. Try and understand the product, correlate it with your needs and requirements and only then go for it. So how much is adequate? A number of components go into the calculations in finding the adequate amount of insurance.

These are:

- Your current age
- Inflation adjusted returns
- Number of dependent in the house
- One-time cost (which includes any existing loans that you may have taken, (exclude the home loan which is already insured against declining term insurance) and any other expenses such as last rites expenditure)
- Your current cost of living (only include the fixed and variable mandatory expenses. Exclude any mandatory expenses related to you since these expenses will cease to exist after your demise)
- The amount needed to pay off responsibilities like your child's education and marriage
- Exiting investments
- Any existing life insurance

All these factors help in finding the adequate amount of life insurance. Hence if you have any existing insurance then you only need to buy the additional amount. NOTE: If you are no more an earning member of the family, that is, if you have retired, then you should not take any life insurance.

Health insurance

A must again with the increasing amount of stress that the younger generation is facing, we would not be surprised if you have already started running huge amounts of medical bills at a young age. A minimum amount of Rs.2 lakh is a must. If affordable increase the amount. Also, if possible, try to take individual policies as against family floater plans.

This is because if you have a floater health policy worth Rs.3 lakh, and you fall sick and use up an amount of say, Rs.1 lakh worth of health insurance, only Rs.2 lakhs will be available for the rest of the year for you and your entire family.

In fact, now individuals have an option to go for a top-up, that is, if you have an existing policy with your employer or you have bought it one yourself then you can top it up to Rs.10 lakh. The premium amount works much cheaper. For example, say you have Rs.5 lakh of health insurance (this is the maximum offered by most health insurers today) and you would like to be insured for more than that then you could buy a top-up plan for another Rs.5 lakh.

So, if you have a medical bill of Rs.7 lakh then the first Rs.5 lakh are covered by your existing policy and the balance Rs.2 lakh by the top-up policy. NOTE: It is very important to pay your insurance premium on time and see that it does not lapse especially for individuals who are nearing 60 as after this age very few insurance companies offer health insurance and to get a new one is very difficult. Also, for people who are working and have not taken any other mediclaim policy besides the one their company offers them, remember that once you leave the job and find a new one, you might no longer be covered by that policy.

Disability insurance

Again, an important insurance policy, especially, for individuals who travel frequently. Accidents can happen anytime and if it leads to any disability then well let's not even think about it. This policy is not an expensive one though. There is also an option for individuals to take this insurance as a rider along with their life insurance.

Compare the premium amounts of a standalone policy and the premium if it is taken as a rider and then decide which one is better.

Property insurance

Your hard-earned money has gone in setting up your house. If something were to happen to it, or maybe something is stolen then it is difficult to replace. So it is always advisable to have your property insured. The premium amount is low and hence this amount will not pinch your pockets.

The only hitch is that in India, property insurance is for the market value and not for the replacement value of the property. But this should not be an excuse for not taking property insurance.

Professional indemnity insurance

This insurance policy is a must for all professionals to protect them from any claim arising during the course of their business.

I know it sounds like too many insurances at one time will leave you with no money for other investment planning but the ones mentioned here are amongst the most commonly needed ones. The most important are the life insurance and health insurance and for individuals who are nearing their retirement age or are retired for them health insurance a must. Once these two are in place you can buy the others eventually. Once we are assured that your risk is managed, we do not have to worry about it anymore. Now we can safely move towards investing and planning to achieve your goals.

Investment planning

Why do we invest?

Of course, to save money and earn returns! For what?

Your obvious answer would be: for my and my family's future. If asked to elaborate, I am sure you will find it difficult to list down five things for which you are saving money. But if the investments or the money you are saving is not invested in right investment avenues then in the hour of crisis you either have invested in a locked-in financial product or their value has become half or in a product which rates very low in liquidity (like real estate). So, the right type of investment product is very important to help your money grow and in achieving your goals.

So this is where investment planning comes in place. Investments of your hard-earned money should always be done considering your goals and the time frame in which you want to achieve your goals. The next question is how to go about it. First you need to start with charting, that is, writing down your goals and the time frame in which you would like to achieve them. This forms the base of your investments. To make the task simpler, you can break down your goals into three different sections:

- Responsibilities: Providing for your dependent parents; funding for your children's education and marriage; funding for marriage of your siblings, etc.
- Needs: Buying a house, saving for retirement, buying office space and any other needs you may have
- Dreams: Finally, your dreams or your aspirations which can range anywhere from buying a solitaire for your wife to going on a world tour to buying a sports car

We live only once and so no dream is too big or far-fetched. The next step is the time frame in which you would like to achieve it. Let me explain the importance of this via an example.

Let us say you want to save for a down payment for the dream car, which you are planning to buy after a year and a half. You start saving by investing regularly in equity mutual funds. After a year, just nearing the time frame you have set for yourself, you decide to redeem the investment and the market crashes. Forget the profit, your initial investments too have halved in value.

Equities are good investments but only when you have the time frame of more than eight years. Then you can be rest assured that your investments will earn on an average 13 per cent to 15 per cent return.

Moral of the story:

Your investment products should be selected on the basis of the time frame within which you would like to achieve the goal. It may be difficult to list down a time frame but even an approximate figure will do.

Once your goals and time frame is in place you need to put a figure or an amount that you would like to spend for that particular goal at today's value. Say for example, one of your goals is to save for your child's higher education, which is 15 years from now. You are willing to spend Rs.3 lakh in today's value. To this will be added inflation which in layperson's terms means what you will get in today's date for Rs.100, you will have to spend Rs.275 after 15 years taking into consideration an inflation rate of 7 per cent.

We cannot forget inflation as the amount, which we will derive after taking into consideration inflation, is the amount you will have to spend. Also, keeping in mind this amount you need to plan for it. So, for the same goal, which will cost you Rs.3 lakh in today's date, you will have to spend Rs.8,27,709 after 15 years taking into consideration 7 per cent inflation rate