PGIM
India Mutual Fund

Default options can help build good financial habits.

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Dear Investors and Partners,

As one transitions from teenager to adult, and starts earning for the first time, the thing that defines this change the most and prepares one for the ‘responsibility’ phase of the life to follow, is the need to manage finances on one’s own. As a young professional, the overwhelming urge is to spend all the money probably on gadgets, travel, eating out etc., and perhaps think about savings and investment a few years down the line. Not to sound preachy, I have done the same in the early part of my career.

Of course, as a young professional one cannot be blamed for thinking like this, and I am not suggesting even remotely that people in this phase are irresponsible. On the contrary, I feel India’s young generation is the most aware, savvy and responsible as far as life choices are concerned. I am constantly amazed in my interactions with them on their clarity of purpose. But then, what defines this anomaly when it comes to saving and investing? I think, it is the mental math that prevents thinking about savings at a young age, influencing behavior and investing decisions. Let me explain this with the help of an illustration. One Ms. Sonali, an individual in her 20s, earns an annual salary of Rs 5 lakh. She wants to save for purchasing her own 1-bedroom apartment (estimated to cost Rs 1 crore after 10 years) in her 30s. Ms. Sonali will have to invest approx. Rs 54,000 per month to reach her goal, assuming annual returns of 8%. And here lies the problem! This amount is around 130% of her current monthly salary. As a result, saving for such a goal becomes a mental non-starter. At best, Sonali can be expected to save and invest 50% of her salary. But then, she will be able to afford a house only in her 40s and not earlier. We can see the mental challenges that young professionals have when it comes to investing early on. Either the goal is out of reach, or it is too far out in the future. In this age of instant gratification, this is a behavioral problem that most financial advisors struggle with.

The solution, in my opinion, is to focus on developing good financial habits and not think about outcomes at this stage. In an increasingly digital “click and buy” world, this is easier said than done. However, financial success is dependent predominantly on good financial habits in the long run. An easy hack to develop this for individuals is to start by contributing into the provident fund (PF), either voluntarily through Public Provident Fund (PPF) or through additional employee contribution known as Voluntary Provident Fund (VPF). However, the rate of interest, tenure and certain terms & conditions may be different between the various options. PF has some interesting inherent features that a young investor can find very useful and can be replicated across other investment avenues once she gets into the voluntary investing habit. This investment is meant for the farthest goal in life: Retirement. Firstly, the money is deducted upfront from the salary, instilling a discipline in the whole process. Since the employer also contributes, the smaller corpus can add up without us even noticing. Secondly, there are restrictions on early withdrawals, which ensures one stays invested and enjoys the benefit of compounding. From a taxation viewpoint, PF is very efficient and provides for tax exemptions. Post-tax returns are an important aspect for every investment avenue. A suggestion for younger people who can afford to do so, is to buy a term insurance and health insurance early on in their career, over and above of what their employer provides. This will be beneficial if they are ever temporarily out of job, and will provide flexibility and the premium may also be lesser at this early stage. Younger people can also start contributing to an ELSS scheme in subsequent years, so as to not scramble for tax optimization at the last minute, in addition to contribution to PF and insurance premium.

Let’s say Ms. Sonali contributes Rs 5,000 per month to PF in the 1st year and the investment yields 8% annual returns. If we assume that her salary increases 7.5% every year, Sonali will accumulate approx. Rs 1 crore in around 25 years, without her even noticing this. The takeaway is that it is okay to save a smaller percentage on a monthly basis in the beginning. The automatic PF contribution would help one build a decent corpus over the long run. That is the beauty of PF, and this takeaway can be carried to any other investment avenue, with underlying principles of financial success remaining the same. Save whatever you can, make regular investment, increase this contribution annually, stay invested for long-term through all market ups and downs and do not withdraw from this corpus as far as possible before reaching your goals.

Stay safe & happy investing.