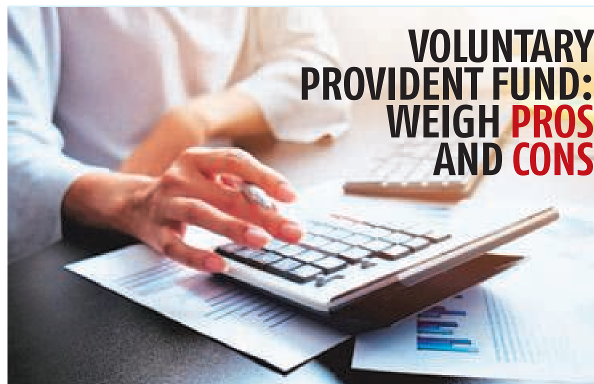
Align investments with financial goals and asset allocation needs

Ensure they are also in sync with your investment horizon and liquidity requirements

SANJAY KUMAR SINGH &
KARTHIK JEROME

Recently, while reviewing a woman client's portfolio, a financial planner found a child insurance plan. These plans are typically used by parents to secure funds at milestones related to their child's education and marriage. When asked why a single woman like her had purchased the plan, she said the institution that had sold it to her had said it would help her save tax.

During the prime tax-saving season from January to March, financial intermediaries push their products aggressively. In their rush to complete their tax-saving investments and provide investment proof to employers, many investors in the old tax regime purchase products that don't align with their needs.



Pros
- Zero credit risk
- Attractive 8.15% return

Cons
- The rate of return can change every year
- Long lock-in is another issue (withdrawal is only allowed in special circumstances)
- Return from EPF/VPF is taxable at slab rate once contribution exceeds ₹2.5 lakh per year
- Section 80C deduction is available only up to ₹1.5 lakh

Bottomline
- Invest if you have not touched the ₹2.5 lakh limit, are underweight on fixed income, and don't mind the lock-in
- Beyond ₹2.5 lakh, invest only if you are okay with the post-tax return (equity mutual funds could offer much higher returns over decades and have no lock-in)

Key considerations

When buying a tax-saving instrument, one should not lose sight of a few critical considerations. The first is financial goals. "The instruments you invest in must align with your financial goals," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.

Asset allocation is another critical aspect. "If your asset allocation requires that you invest in equities, go for an equity-linked savings scheme (ELSS)," says Renu Maheshwari, Sebi-registered investment advisor, co-founder and principal advisor, Finscholarz Wealth Managers. Similarly, investors whose portfolios are already skewed towards equities should choose fixed-income options.

"Investing excessively in equity can be risky in an emergency. You could incur a loss if you are forced to liquidate during a market downturn. Conversely, overreliance on fixed-income products is inadvisable as equity is needed to beat inflation," says Dhawan.

Investors should consider a product's tenure and lock-in period to ensure it aligns with their cash flow requirements. Says Arvind Rao, founder, Arvind Rao and Associates: "Many tax-saving products have a lock-in and may require you to stay invested from three years to over a decade."

Product expenses, according to Dhawan, should be another key criterion in selection.

Fulfil insurance needs first

Tax planning should ideally begin by safeguarding against key risks through the purchase of life and health insurance (premiums are eligible for Section 80C and Section 80D deduction respectively).

Term insurance is a cost-effective option for safeguarding against the risk of the breadwinner passing away early. "Buy term insurance equal to at least 10 times annual income," says Kapil Mehta, co-founder, SecureNow.

The policy's tenure is important. "An individual aged 35 who aims to retire at 65 should ensure financial security for dependants with a policy term of 30 years or more," says Indraneel Chatterjee, co-founder, RenewBuy.

Make sure that you have adequate health insurance for your family's needs. "The coverage should be sufficient to fully cover major medical procedures, like a bypass surgery or cancer treatment, at a hospital near your home," says Mehta. According to him, a family living in a metro must have a sum insured of at least ₹10 to 15 lakh or equivalent to one year's annual income. Chatterjee emphasises that the sum insured must factor in the town one lives in (buy more if you live in a metro) and family size. The plan you buy should have the minimal exclusion for pre-existing conditions and the room you are eligible for should meet your lifestyle expectations. Also, check the insurer's claims payment track record.

Meet investment needs next

ELSS: This is an equity product. "It has the potential to offer high returns and also comes with the shortest lock-in of three years among all tax-saving investments," says Rao.

Being equity-based, these funds can, however, be volatile.

Maheshwari suggests investors examine their portfolios and see whether they need a large-cap, flexi-cap, or mid- and small-cap oriented fund and choose an ELSS accordingly.

Dhawan suggests investing through the systematic investment plan route and having a horizon of at least seven years (though the lock-in is only for three years).

Public Provident Fund (PPF): PPF, a government-backed product, offers an attractive tax-free return of 7.1 per cent. Investors also get a tax deduction of up to ₹1.5 lakh at entry. They should, however, be comfortable with the 15-year lock-in (limited liquidity is available after five years). The amount that can be invested in a financial year is capped at ₹1.5 lakh.

Invest in PPF if your financial goals allow you to lock in money for a long period and investing in it aligns with your asset allocation.

National Pension System (NPS): Investors can choose their allocation to equities and debt and select their fund manager. It is also cost-efficient. The exposure to equities can translate into higher returns over the long term. Investors also get a tax deduction of ₹50,000 under Section 80CCD(1B) over and above the Section 80C deduction. Upon retirement, 60 per cent withdrawn as a lump sum is tax-free.

On the downside, NPS has a long lock-in. If one withdraws before retirement, 80 per cent of the corpus must be annuitised. Upon retirement, 40 per cent of the corpus must be used to buy an annuity, whose interest payouts are taxed at slab rate.

Go for NPS if you need to save for retirement and have investments in other products that can offer you adequate liquidity.