How to inflation proof your savings and investments?

Before we look at the options available to make your investments inflation proof, let us understand the costs of inflation.

Suppose you earn a return of 10% per annum on your bank deposits and rate of inflation is 8% in the economy. A lunch that used to cost Rs.100 would cost Rs.108 at the end of the year. This means, you must earn a return of at least 8% per annum to be able to buy that lunch. Since your bank gives you a return of 10%, you are happy because even after you buy your lunch, you are left with Rs.2.

Wait a minute. Is something wrong in our assumption? Have we forgotten anything? Yes, what about TAX? Tax is levied on *nominal* interest rate. So we need to rework our above assumptions.

Suppose that you earn a return of 10% per annum on your bank deposits and tax rate is 33.99%, the net of tax return is 6.6%. You have to make this adjustment first, because spending on lunch will not give you any tax exemption. Now if you want to buy the lunch you can't. Because, lunch costs Rs.108/- and after paying your tax you have only Rs.106.60.

In reality, if inflation is 8%, price of lunch will increase by more than 8% because of what economists refer to as 'shoe leather costs' and 'menu costs'. 'Shoe leather cost' literally means the wear and tear of your shoes to run around to manage the effect of inflation and 'menu cost' is the cost businesses incur to physically change the prices – printing new menu or catalog, replacing labels and advertisements in stores and so on. It is estimated that when inflation is 5%, 'shoe leather cost' can exceed 0.3% of GDP. You also know that indices adopted by the Government to measure inflation may be outdated and may not include all the products and services you consume. So 'practical rate' of inflation could be much higher than 8%.

Now let's look at options available to you in order to earn a 'real' return so that you can buy a full lunch at Rs.108/-

Earn a higher return - this may not be possible as rates of return are market driven. You must be cautious if someone promises a return much higher than market rate of return. It is a clear indication that you capital is under risk.

Earn tax free return – there are few conventional savings products that are safe and yet provide you tax free return such as Provident Fund, PPF accounts. But they are not liquid and have upper limits. Debt funds and fixed maturity plans are a good alternative to bank fixed deposits to earn tax free returns in your hands. If you are worried about safety of mutual funds, it is as safe as the overall environment is and well regulated by SEBI. Safety net provided on your bank fixed deposits is only Rs.1 Lakh per bank under Deposit Insurance & Credit Guarantee Scheme of India.

Asset allocation – with a good marriage of risk management and asset allocation strategy, you can aim to generate positive 'real' return in the long term. Consult your financial planner so that he can device a suitable strategy that can help you keep buying that lunch without worrying about tax and inflation.