Personal Finance

FINANCIAL PLANNING

The dream home dilemma

Sameer Kaul | | Updated on October 11, 2020 | Published on October 11, 2020

Most of us aspire for a bigger house. But how feasible is it? Here is a case study

Alka and Shobhit Mehra, aged 43, live in Mumbai. Shobhit has risen to become the head of the risk solutions group at a consulting firm, while Alka is an acclaimed fiction writer. Their son Rahul (13) and daughter Meera (10) study at a premier international school.

Alka has set her heart on a recently constructed apartment building in the premium Bandra (West) can't expect more than ₹4 crore from the sale of their existing house.

The move will mean wiping clean their accumulated portfolio which is currently worth ₹3 crore (all in equity and balanced funds) and taking a home loan of another ₹3 crore.

Shobhit's take-home pay after deductions works out to ₹6 lakh per month which pays for their monthly expenses of ₹2 lakh, their annual international vacation that typically costs ₹8 lakh and annual school fees of ₹8 lakh per child per annum.

Goals and costs

Financial goals	Present Value (₹)	Inflation	Time (years)	Future Value (₹)
Rahul's graduation*	30,00,000	10%	5	48,31,530
Meera's graduation*	30,00,000	10%	8	64,30,766
Rahul's post graduation**	60,00,000	10%	9	1,41,47,686
Meera's post graduation**	60,00,000	10%	12	1,88,30,570
Rahul's wedding#	50,00,000	10%	15	2,08,86,241
Meera's wedding#	50,00,000	10%	18	2,77,99,587

*per year payable for four years **per year payable for two years #Assumed wedding age: 28 years

Until last year, Shobhit was servicing EMIs on their Santacruz apartment, which took up another ₹ 1.5 lakh per month. He finally became debt-free only recently and is uncomfortable about taking on a large home loan at this stage in his career.

His annual bonus (₹25-30 lakh pre-tax in the last two years) is what he has been investing in recent years.

Alka's earnings as a writer have been erratic. Her income-tax returns in recent years show a wide range of professional income — from ₹21 lakh to ₹1.08 crore per annum.

Difference of opinion

Shobhit's view is that they should be saving up for their children's overseas higher education and wedding expenses, and for their own retirement.

Alka's view is that Shobhit is denying his family the lifestyle that she believes they deserve and can afford. He still has a good 20 years of work left in him and so does she.

On her part, Alka is willing to be less erratic with her writing commitments — if it means extra income to pay down a home loan for a house she yearns for. Shobhit believes that hoping for a mercurial income stream to suddenly become steady and strong borders on wishful thinking.

Here's the advice we gave Shobhit and Alka.

Assumptions

But first the assumptions. The rate of inflation is 10 per cent per annum for education, wedding expenses and cost of living.

The rate of return per annum is 15 per cent from equity, 7 per cent from debt, 5 per cent from gold and 10 per cent from real estate. The retirement age of Shobhit and Alka is 60 years and their life expectancy is 85 years.

The higher education fees is ₹30 lakh each year for graduation (four years) and ₹60 lakh each year for post-graduation (two years). The wedding expense is ₹50 lakh per child. Shobhit's and Alka's incomes are assumed to increase annually by 10 per cent and 6 per cent, respectively.

Based on the above assumptions, the likely expenses towards various goals are as given in the accompanying table.

Recommendations

So, here's what we recommended based on the two case scenarios — one, don't buy the new house, and two, buy the new house.

Case 1: Don't buy new house

Their current portfolio is 100 per cent in equity. It is recommended to diversify the portfolio by investing in different asset classes so that risk may be minimised. The recommended portfolio is 70 per cent equity, 20 per cent debt, 5 per cent gold and 5 per cent real estate. The expected weighted average return from recommended portfolio is 12 per cent per annum with the deviation of +/- 9.45 per cent, assuming 10+ years of holding period. The expected weighted average returns on a more conservative corpus post-retirement is 9 per cent per annum.

Three years before the occurrence of any financial goal, the pre-decided amount will be shifted from the recommended portfolio to a liquid/short-term debt fund. Seventy per cent of the yearly savings will be invested in the diversified portfolio.

Shobhit should purchase a term insurance cover of ₹7 crore and Alka should purchase a cover of ₹3 crore. They should also purchase a health insurance cover of ₹20 lakh with a critical illness rider of ₹20 lakh.

They should also maintain an emergency corpus of ₹25 lakh at all times. This emergency fund is recommended to be invested in either liquid or ultra-short term debt funds and can be used for any unplanned expenses. Given the above, all the financial goals of the family can be met.

Case 2: Buy the new house

The EMI for the new flat will be ₹2,93,344. Annual savings will come down by almost 50 per cent. Since the existing mutual funds will be used to finance the house, the available provisions will come down to nil. The revised insurance cover required will be ₹16 crore. In this case, Shobit has to either depend on his employee for extra insurance cover or take an additional life insurance cover.

Unlike in the previous case, the emergency corpus can be reserved only for either medical emergencies or EMIs in case of job loss or unplanned events.

It is assumed that 70 per cent of annual savings are invested in the recommended portfolio every year till Shobhit and Alka turn 60.

If the couple purchases the house by taking a loan, there is a high probability that they may run out of their retirement corpus by the time they turn 70 year of age. Excluding retirement planning, all other financial goals of the Mehra family are achievable even if the couple decides to buy the property.

If all the goals are to be met, Alka is required to increase her annual post tax income to ₹81 lakh, maintaining a constant increment of at least 6 per cent per annum. If Alka's increase in income does not increase to this level, the new property could be used to get regular income by opting for reverse mortgage when they turn 65 years of age. This should cover the deficit in the retirement corpus.

The writer is CEO and MD of TrustPlutus Wealth Managers (India)

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