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Financial ratios to track your money health

Apply these four ratios to your financial life to get a perspective of earnings, investments and liabilities

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Personal financial planning might sound like a daunting exercise, but it's really about the right approach to your household budget and then the right kind of investments.

Apart from this, one also needs to check numbers from time to time. When companies declare their financial results, to understand their financial health better, analysts use ratios that show weaknesses, opportunities and gaps. You too can use simple ratios to identify whether you are on track with your finances.

Below are four such ratios that you can apply to your financial life to get a perspective of earnings, investments and liabilities.

What's your worth?

For companies this is defined as total assets less total liabilities, and it shows what the equity in the business is worth.

To translate this into your own finances means determining what your financial worth is net of the loans. Let's say you have liquid investments, including fixed deposits and mutual funds, worth ₹20 lakh, provident fund worth ₹5 lakh and the house you live in is worth ₹1 crore. On the other side of this personal balance sheet is a ₹60-lakh (principal remaining) loan you have taken for the house, ₹30,000 current outstanding on a credit card and a ₹6-lakh (principal remaining) car loan. Your net worth is the difference in the total sum on both sides—₹58,70,000.

Is this enough? That depends on your age, income and future financial commitments.

“Net worth is usually a part of financial plans. It’s an indicator of how funds are allocated,” said Suresh Sadagopan, a Mumbai-based financial planner. He suggests looking at net worth with and without the value of the residential house as the house can’t be counted for future financial goal setting.

Tracking your net worth allows better investment choices. If age is on your side, a high current net worth gives you enough room to take on riskier investments. A low net worth could restrict you to assured income investments.

Abhishake Mathur, head-investment advisory services, ICICI Securities Ltd, said, “Assets, liabilities and net worth are important factors as they define the risk-taking ability. If one has more loans, it increases overall risk and should ideally translate into a more conservative investment strategy. This is especially true to guard against a recessionary environment. In 2008, for example, investors who were over-leveraged found not only the value of their market-linked investments going down, but the value of leveraged assets, including properties, fell alike and their equated monthly instalments (EMIs) increased with rising interest rates.”

What gets included in net worth also needs careful attention.

Deepali Sen, founder and director, Srujan Financial Advisers LLP, said, “For many people, 70-80% of the net worth is in real estate, but this is not liquid. Moreover, the house we stay in is usually the costliest investment. It would be better to have a more balanced net worth, which can be utilised to enhance wealth.”

Too much interest?

Interest rates keep changing and in a rising interest rate environment, your EMIs can well increase beyond comfort. In the period immediately before the global financial crisis in 2008, domestic interest rates were on an upward trajectory.

You might have more than one loan running—two car loans, a housing loan, a second housing loan for that flat you invested in, and also perhaps an EMI for the latest smart phone. Ideally, you should have the liquidity to cover these monthly payments for at least the next few months. Even though you may be getting a monthly salary, unforeseen eventualities could impact regular income.

This is where evaluating your interest coverage ratio—which defines how much cash you have versus your total interest payment—can help.

For companies this ratio is calculated by dividing the annual earnings before interest and taxes by the annual interest expense. You could evaluate your personal interest coverage by deciding how much liquidity you want to create.

“We ask clients to add up expenses and monthly interest payouts. The amount of liquidity to be kept aside depends on the certainty of income. If someone has stable income, then two to three times of expenses can be kept in some liquid form. But where entrepreneurs who face seasonality of income, six months to a year of expenses might have to be kept aside,” said Sadagopan.

Add your cash in the bank plus any liquid investments like short-term fixed deposits or liquid fund investments and divide this by your pre-defined monthly interest payouts . An appropriate ratio can’t be predetermined; it will depend on your individual situation.

Saving enough?

Net profit margin is a figure that analysts like to use to slice and compare to determine profitability of a company. For you, this will mean savings margin.

You have a regular monthly income, and fixed and incidental expenses. Whatever remains after all this is your saving. For example, paying rent, monthly salaries, grocery bills and utility bills are all identifiable fixed expenses. Gifts, eating out and personal shopping are flexible. Lastly, account for EMIs and remove that amount from your monthly income to get your saving figure. The saving margin is this figure divided by your monthly income.

If your monthly saving margin fluctuates too much, try to find the reason. Having a stable monthly saving margin will help you invest better.

Detailing this further, Sadagopan suggests keeping a keen eye on expenses.

“Expenses to savings ratio is also important. A saving of ₹1 lakh might seem higher than a saving of ₹70,000 per month, but it should be looked at in respect of expenses.

The former could be on the back of monthly expenses of ₹2 lakh, while the latter on the back of ₹30,000. How many days of expenses you are able to save is important to track."

There are various ways to arrive at an optimum saving level. "One can work backwards, depending on goals and means for funding. The gaps can be worked upon. The discussion then is on how much to keep aside every month to account for the gaps," said Sen.

Is your income volatile?

Uncertainty of income would be worrying for all. In a company, sales growth is tracked closely to understand how well revenue is growing. In an individual context too, income volatility matters. If you are in a government job, income is a given and so is pension. But if you are working with a private enterprise—especially one that's newly formed—your income growth will depend on company policies, and job security can be an issue.

"Volatility of income and certainty of job also have an impact on the asset allocation strategy. Investors who have jobs with high incentives components or bonus need to have a more conservative investment strategy than those with jobs that are more certain and less volatile," said Mathur.

Income volatility can be due to other reasons as well. "Bonuses are an annual windfall and difficult to account for. But many people bunch insurance payments during particular months, and in those months, other investments become difficult. In festival months, sometimes there is irrational expenditure, which can change the overall money plan," said Sen.

Mint Money take

For effective financial planning, slicing and dicing of financial details is required. But there aren't any specific rules around these numbers, and ratios should be looked at in context to an individual's situation. For example, an interest coverage ratio of two times may be good enough for one family but another may need a ratio of six times. Decision making may differ but adopting some method of evaluation can make results more effective.

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TOPICS: **NET WORTH** **SAVING** **INCOME** **LIQUIDITY**

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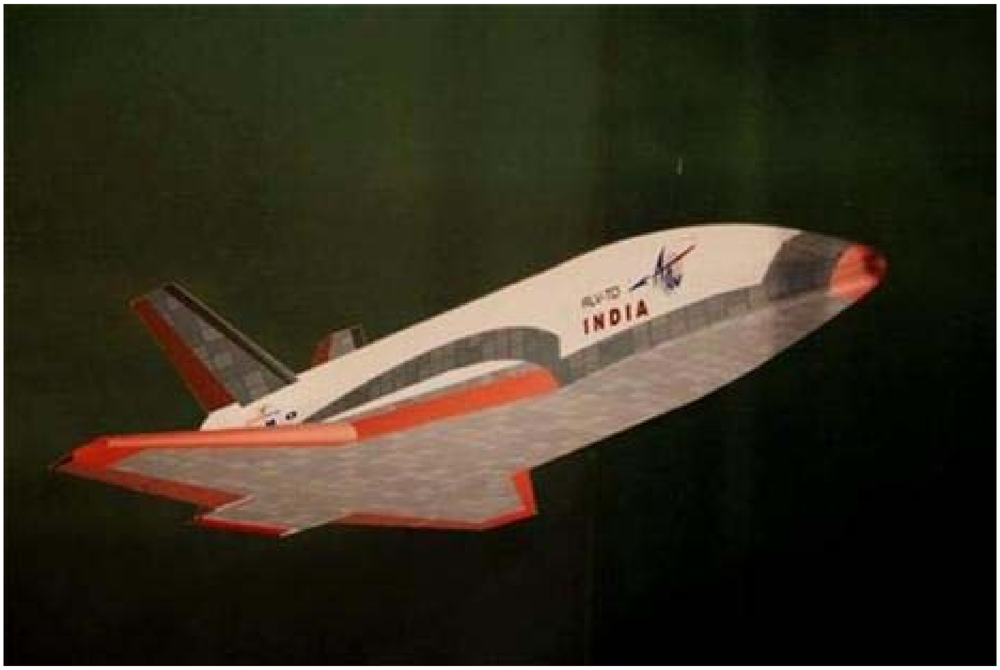

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