Understanding Time Value of Money & Inflation

It is crucial that investors fully understand the concept of time value of money. Not only does time value affect actual investment returns, but it also influences how investors choose their investment instruments. Time is your enemy if your money languishes in a low return instrument. Likewise, time is your friend if you have carefully chosen the right investment.

Time Value of Money

Understanding time value of money is one of the most important elements in determining our financial decisions and a key concept to understand before we embark on any investment. There is a time value to money because it can be invested for the future. When money is invested, one of the main factors affecting its value over time is inflation. Inflation reduces the real value of money over time. A Ringgit will generally buy less goods and services in the future as inflation erodes its real value or purchasing power over time. Although the face value of the Ringgit is the same, the purchasing power of money is higher today than in the future.

Inflation's Impact on the Real Value of Money

Inflation is defined as a rise in the prices of goods and services and it reduces the real value of money over time. As a result of increased inflation, your money can buy fewer goods and services today than it could have bought in the past. Thus, inflation erodes the purchasing power of money.

But, as an investor, what is the impact of inflation on the value of money? To get a "real" rate of return, investors need to subtract the inflation rate from their nominal investment returns. For example, a fixed deposit (FD) that yields 3% p.a will provide a positive real return of 1% p.a assuming an inflation rate of 2% p.a.

Some investors prefer to put their savings in a safe but low-yielding asset, such as the FD, to preserve their capital. However, they invariably ignore the effect of inflation on their savings.

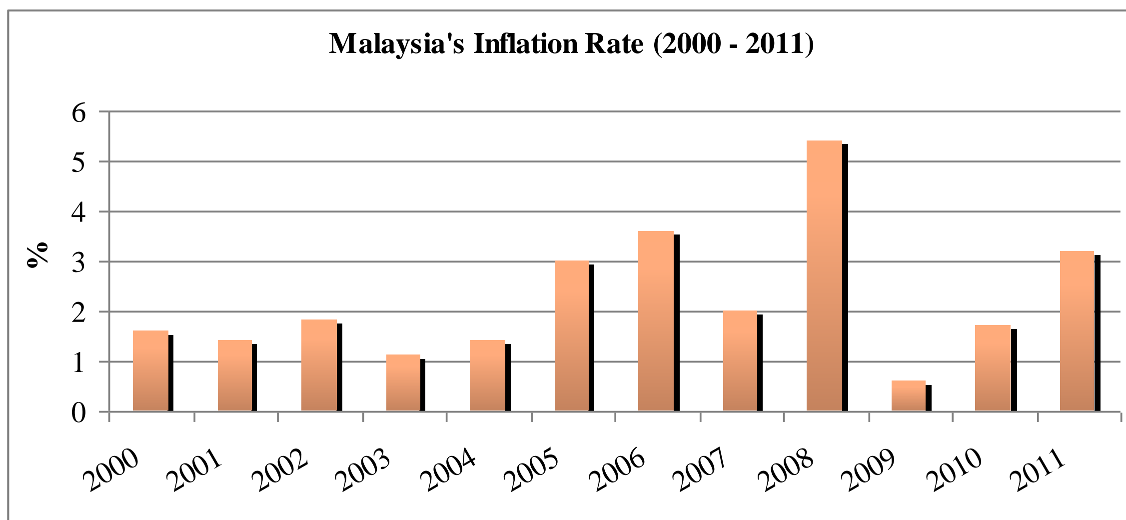
Let us look at the following table to see how inflation affects various asset classes such as savings held in bank's FDs and equities (as proxied by the FTSE Bursa Malaysia KLCI Index (FBM KLCI) over the past 12 years.

Table 1: FD and KLCI Nominal Returns Vs Real Returns

Year	%				
	Inflation	12-Month FD Returns*		FBM KLCI Returns	
		Nominal	Real	Nominal	Real
2000	1.6	4.1	2.5	-16.3	-17.9
2001	1.4	4.2	2.8	2.4	1.0
2002	1.8	4.0	2.2	-7.2	-9.0
2003	1.1	3.8	2.7	22.8	21.7
2004	1.4	3.7	2.3	14.3	12.9
2005	3.0	3.7	0.7	-0.8	-3.8
2006	3.6	3.7	0.1	21.8	18.2
2007	2.0	3.7	1.7	31.8	29.8
2008	5.4	3.7	-1.7	-39.3	-44.8
2009	0.6	2.6	2.0	45.2	44.6
2010	1.7	2.8	1.1	19.3	17.6
2011	3.2	3.1	-0.1	0.8	-2.4
Average (2000-2011)	**2.2**	**3.6**	**1.4**	**7.9**	**5.7**

** Average 12-month FD rate*

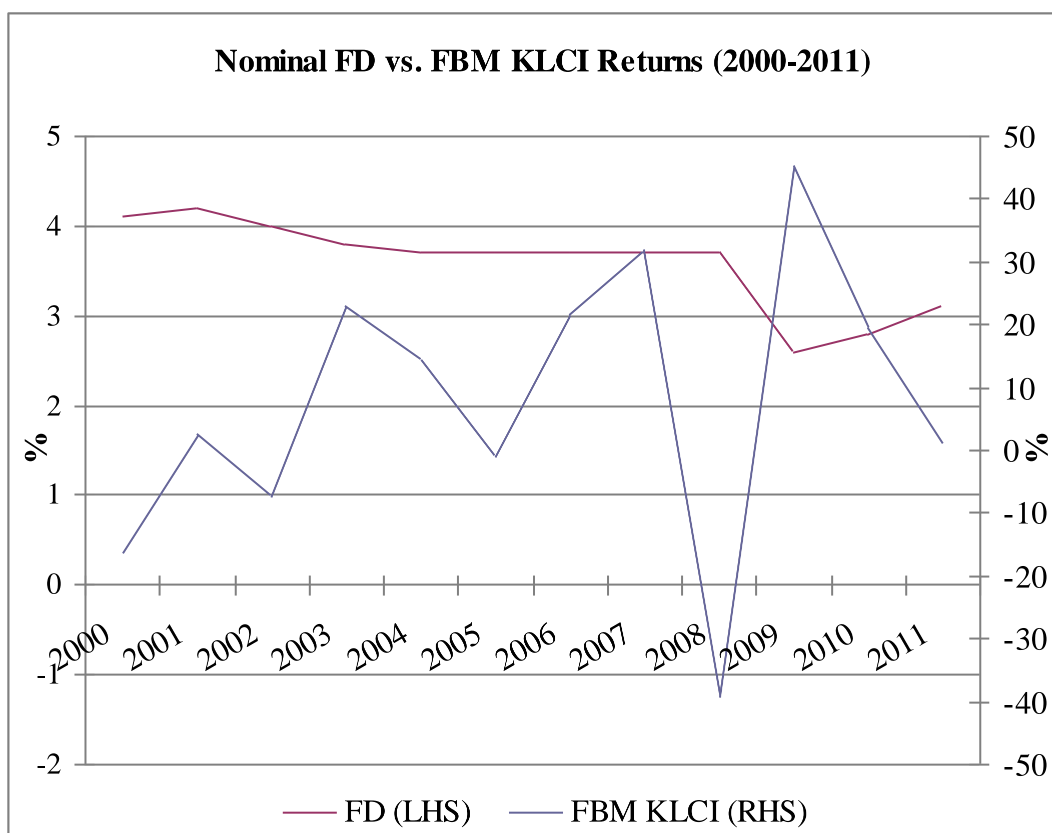
As shown in Table 1, Malaysia's inflation rate increased over the past 12 years with the highest inflation rate recorded at 5.4 percent p.a. in 2008 amid a surge in fuel prices. After easing to a low of 0.6 percent in 2009, Malaysia's inflation rate normalised to the 3.2 percent level in 2011.



On the other hand, the average nominal 12-month FD returns had generally been on a downward trend since 2000 and bottomed out in 2009 due to an easier monetary policy amid the challenging global economic environment. The average nominal 12-month FD returns subsequently increased in 2010 and 2011 as Bank Negara Malaysia (BNM) raised interest rates in line with Malaysia's economic recovery.

Over the 2000 to 2011 period, the average 12-month FD registered lower returns in real terms due to the higher inflation rates during this period. For instance, in periods of increased inflation as in 2008 and 2011, the real returns of the average 12-month FD turned negative at -1.7% and -0.1% respectively.

In comparison, despite recording sharp declines in selected years due to the retracement in global markets, the FBM KLCI generally registered higher returns in nominal and real terms over the 2000 to 2011 period compared to the average 12-month FD as shown in Table 1.



Overall, the FBM KLCI registered a higher average real return of 5.7% over the 2000 to 2011 period compared to the real 12-month FD return of 1.4% over the same period.

In the near term, the FD returns in Malaysia are expected to continue to remain low as BNM is expected to maintain an accommodative monetary policy in view of slower global economic activities amid the ongoing sovereign debt issues in developed economies. To keep ahead of inflationary pressures, it is advisable for investors to diversify into other asset classes such as equity funds. However, investors should note that the higher returns potentially generated from higher yielding assets invariably come with higher risks. Thus, investors need to manage their asset allocation between the asset classes in accordance to their risk profiles.

Conclusion

Understanding the time value of money is crucial before making an investment so as to better evaluate the potential investment options available. We can then start off by finding a good investment product with a reasonable expected return that can more than offset the negative effects of inflation. The knowledge of time value calculations is a valuable skill to get real smart about how money works. The key to financial prosperity is realising the potential value of every Ringgit that comes into our hands.

For more information, please contact Public Mutual's Hotline at 03-6207 5000 or visit www.publicmutual.com.my.