PGIM
India Mutual Fund

Understanding Real Rate of Return, and It's Impact

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Dear Investors and Partners,

Mehengai or Inflation has a profound impact on all stakeholders – companies, investors and the economy at large. Governments, economists, and bankers keep a close eye on how inflation is managed by central banks. Economies around the world have been grappling with heightened inflation, especially in the aftermath of geopolitical uncertainty and supply side constraints.

In the realm of investing, we understand how important it is to beat inflation to earn a positive rate of return. Beating inflation assumes importance especially to keep the purchasing power of our money intact for our long-term goals like retirement.

Thus, dissecting your portfolio return by taking inflation into account is essential to understand how well you are prepared to achieve your long-term goals. Let's understand the concept of Real Rate of Return, its impact on your portfolio, and why it is essential to consider it when planning for your long-term goals.

What Is the Real Rate of Return?

The Real Rate of Return represents the annual percentage of profit earned on an investment, adjusted for inflation. Unlike the Nominal Rate of return (which does not account for inflation), the Real Rate of Return provides a more nuanced measure of investment performance. Let's understand how it is calculated:

Nominal Rate of Return: This is the percentage gain or loss on an investment without considering inflation. For example, if a portfolio returns 10% per year, that's the nominal rate of return.

Inflation Adjustment: To calculate the real rate of return, we remove the impact of inflation from the nominal interest rate. The formula is as follows:

Real Rate of Return = [(1+Nominal Rate of Return) / (1+Inflation Rate)] - 1

Why Is the Real Rate of Return Important?

Understanding the Real Rate of Return is critical for several reasons:

Purchasing Power: The Real Rate of Return reflects the actual growth in purchasing power. If your investments outpace inflation, your wealth increases in real terms.

Portfolio Planning: When planning for retirement or other such long-term goals, you need to estimate how much your portfolio will grow over time despite regular withdrawals to sustain your lifestyle during your retirement period. Relying solely on nominal returns can lead to inaccurate projections, impacting your retirement kitty and thus your withdrawal rate.

Let's illustrate this concept with an example:

Portfolio Returns:
Suppose you invest INR 1 crore in a portfolio with a nominal return rate of 10% per year and the current inflation rate is 6%. Here's how you arrive at the Real Rate of Return:

Real Rate of Return = [(1+10%)/(1+6%)] - 1 = 3.77%

In this case, relative to the nominal rate of return of 10%, your real return is barely touching 4%. This Real Rate of Return implies that, if the inflation rate hovers at 6%, your purchasing power increases by approximately 4% annually.

Now, suppose if you were to withdraw 6% of the corpus every year to manage your expenses, the corpus, in this case will last for only 27 years.

Withdrawal rate > Real Rate of Return	
Corpus	INR 1,00,00,000
Nominal Rate of Return	10%
Inflation	6%
Withdrawal Rate	6%
Real Rate of Return	4%
Corpus will last 27 years.	

With a withdrawal rate of equal to, or less than the Real Rate of Return, your corpus will never run out and shall last life-long.

Impact on Portfolio Depletion

The concept of Real Rate of Return is significant in the context of retirement, particularly during the withdrawal phase.

If your withdrawal rate (the amount you withdraw annually from your portfolio) exceeds the Real Rate of Return, your portfolio may deplete over time. Hence, financial planners often recommend a Safe Withdrawal Rate (SWR) which should be less than the Real Rate of Return. If you withdraw more than SWR, your portfolio might not sustain longer unless you have a supplementary income to fall back on.

To conclude, understanding the Real Rate of Return empowers you to make informed investment decisions and plan for a financially secure future. It pays to be conservative in your withdrawal rates and consider the impact that inflation have on your savings. It's better to err on the side of caution to avoid prematurely depleting your hard-earned savings.

Happy Investing!

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