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Asset allocation – A boon to your investment

In February 2017, when I had just joined the mutual fund industry, (early days as I would like to call them), I had spoken at a conference about my experiences – both good and bad with asset allocation. In fact my own investment mistake in 2005, of over-allocating to equities right before the financial crisis, helped me discover the power of having a balanced portfolio regardless of what your own risk profile is. If anyone believes in the proverb, "Don't put all your eggs in one basket", the need for asset allocation is obvious and in fact, when we read any investment books, the two most frequent used words are "asset allocation" and "diversification". But behind these big words, what does asset allocation actually mean, and how it can be implemented, starting Monday morning?

Since monsoons are its peak in Mumbai, let's think about the vendor who sells umbrellas, but also sunglasses, because the weather is unpredictable, and his business has to survive other seasons too. Investors too, in surviving seasonal asset classes and markets, have to invest in a mix of asset classes across time. Asset allocation, simply put is just creating that balance correctly.

Understand time and risk: While the specifics of asset allocation differ from one individual to another, the broad approach is governed by three main factors: the investor's goals, risk profile and time horizon. Your investment time horizon is the expected number of months, years, or decades that you need to stay invested to achieve a specific financial goal. A longer investment horizon gives you the liberty to include high-risk investment instruments in your portfolio as market volatility gets smoothened out over the long-term. In contrast, an investor with a shorter time horizon might stick to less risky options. Additionally, investors might not achieve optimal diversification just by merely spreading their investments across assets. Categories within the broad asset classes of debt and equity carry varying levels of risk that behave differently over time, and can impact the overall risk of the portfolio. While a large cap fund, by virtue of being categorised as an equity asset, would fall into the high-risk bucket, it might be less risky as compared to a credit risk fund.

Differentiate between strategic and tactical: Asset allocation has two components, strategic and tactical, and bucketing them clearly is important. Your strategic allocation is your core base, - and drives a lot of your investment results. This is essentially about creating a target allocation for various assets, which depends on an investor's long-term goals and risk tolerance. This is the buy and hold portfolio where you maintain your allocations and rebalance only in response to a change in the financial landscape or personal circumstances. Your tactical allocation is the cherry on the cake. It is the active strategy that tries to capitalize on short term market moves, and should be treated like a cherry. Tactical asset allocation comes with higher risks, because timing the market is difficult, and hence should be kept to a small part of the portfolio.

Never forget goals: Any investment strategy ultimately exists to help achieve certain financial goals. Investing without goals, is driving without a destination – frustrating and futile. Of course, determining an appropriate asset allocation model for a financial goal can be a complicated task. While the idea is to simply pick a mix of assets that offer the highest probability of meeting your financial goals within the desired level of risk, in reality, this can be very challenging to execute. Investors can create customised asset allocation strategies to meet their different objectives. A young investor who's saving for his retirement i.e. a long term goal, may allocate a larger portion of his investment to equity funds while another who might be saving for - purchasing a home in the next 10 years might choose to spread his investments over equity funds, fixed-income funds and/or balanced funds. At the other end of the spectrum could be an investor who is saving to purchase a car in the next year and might choose to create a conservative investment mix of fixed deposits and short-term bond funds.

Benefit in different market conditions: The core principle of an asset allocation strategy is to gain exposure to multiple asset categories that respond differently to certain market conditions. Historically, the returns from the major asset classes have shown little to negative correlation, implying that while a certain portion of the portfolio might react negatively to a particular development, there is another portion of the portfolio that might react positively to the same development. In addition to mitigating portfolio risk, asset allocation has many other benefits that can help optimise portfolio returns. Systematic rebalancing prevents the need for an investor to constantly try and time the markets. Since an asset allocation strategy dictates a percentage-based allocation to debt and equity assets, any change in the portfolio value or skew in asset performance can be systematically handled by adhering to the asset allocation strategy.

Asset allocation also helps overcome biases in investing - and over-allocating to recently high performing asset classes. Since an asset allocation strategy is fairly objective and scientific, it can prevent investors from taking portfolio decisions that could hurt their return mandate. Assume that an investor has allocated 60 percent to equity funds, 30 percent to fixed income funds, 5 percent to fixed deposits and 5 percent to cash. Now, in a bull market, the value of the equity portion is likely to grow and take a higher proportion in the overall asset allocation mix. However, as the value of equities grows, an investor is plagued with multiple questions. "Should I book profits at current levels or wait it out for higher returns?" or "Should I follow the herd and continue increasing my exposure to equities?" The answer to both these questions lies in your asset allocation strategy. If your asset allocation strategy requires you to maintain an equity exposure of 60 percent, then as this exposure goes beyond 60, maybe to 75 percent, it would indicate that it's time to book profits and bring the exposure down.

Incidentally while addressing the same conference, I had concluded that a simple way to start asset allocation was a balanced portfolio of domestic equities, fixed income, international equities and gold. In these three years, we have seen cycles in all these asset classes, including the latest fascination for gold – a star asset class in the last few months. I actually did the math – in this period, the balanced portfolio, the basic and simple one, that blended all these asset classes, would have beaten any individual asset class outright, with much lower volatility. A great outcome, albeit unglamorous, but then again - most good things in life, including money, are simple.

Happy investing – or rather asset allocating!