Edelweiss MUTUAL FUND
Ideas create, values protect

Insights

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Dear Investor,

As May comes to an end, I can't help but wonder that while the headline index numbers look benign, if there is one way to describe the month that went by, it is volatile. The large correction in the mid-cap index, compounded by a number of local and global news items, as well as single stock stories, kept many of us on our toes. As I wrote a few months ago, we are living in a VUCA – Volatile, Uncertain, Confusing, and Ambiguous – world and May was just testament to what may be in store.

Inevitably when markets are volatile and correct, the question of "What should I do?" comes up. Should I buy more at these levels, should I exit, should I selectively add? And if I have to do something, what is the right time to do it? And what is the right metric that decides that right time – a level on that index, a certain DMA or a certain PE ratio? And of course, should I not do anything at all?

We do believe that in the world we live in portfolios cannot be static. Static portfolios are built on the assumption at some level, that markets will deliver a static 10-12% a year. The truth is averages have a flaw – any particular investor's experience will vary widely from expectations. Investors also have different investment time horizons, and markets don't necessarily confirm to them. The truth is also that assuming the world is static is dangerous because the world ahead of us may be very different from the world of the past few years – higher valuations, rising rates in the US, a shift from globalization to localization among other factors.

Navigating these unknown waters requires adapting to changing tide, rather than charting a single fixed course. Adaption is key to investment survival in the real world, demanding that asset allocation in portfolios be dynamic rather than static. Asset classes that are doing well should be rewarded, and asset classes that are negative should be avoided. In fact, most investment literature indicates that 90% of an investor's returns are determined not by fund selection or stock selection, but by asset allocation – being in the right asset class at the right time. The dynamic asset allocation or balanced advantage category of mutual funds today, addresses exactly this.

Approaches to Dynamic Asset Allocation

One approach to asset allocation, and the natural instinct is to leave it to the human – or fund manager judgement. Human decision making, as we all know is naturally biased, particularly when it comes to taking "a view on the market" and as research has proved, fairly unreliable. A number of studies show that experts making predictions about the future are slightly better than chance, and in many cases simple models or algorithms have outperformed them because they don't have behavioural bias. The good news is that most dynamic asset allocation funds in India now adopt a disciplined and model driven approach. The bad news is, that we often paint all "models" or dynamic funds with the same brush stroke, when in fact there are multiple approaches to dynamic asset allocation.

The most commonly talked approach to asset allocation is the value based, or what we call counter cyclical approach. Valuation signals like P/E, P/B and Dividend yield are used to adjust the allocation to equities – as valuations fall, equity exposure rises. This takes off the conventional, buy low and sell high theory that applies to individual stocks.

A second approach, that is less talked about, but used extensively globally, is what we call a more pro cyclical approach. The pro-cyclical approach believes that markets follow broad trends and tries to understand, using price driven signals, when markets are doing well. When markets are healthy, the models increase equity allocation, and when they are in decline, the models reduce equity allocation.

What is the right approach?

There is no right answer, and both approaches have their merits and disadvantages. To answer this question objectively, we looked at data for both a pro-cyclical (trend based) and counter cyclical (value based) approach, compared to the NIFTY (below), and saw how each approach to timing between debt and equities would have worked historically.

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018*	Total
Nifty 50	36.3	39.8	54.8	-51.8	75.8	17.9	-24.6	27.7	6.8	31.4	-4.1	3.0	28.6	2	12.9
Counter Cyclical	21.6	19.3	11.8	-18.3	60.4	7.2	-14	21.5	5.0	19.5	-1.1	4.1	13.4	0.8	9.8
Pro-Cyclical	31.2	41.7	47.3	-2.7	59	19.1	-4.4	20.2	6.4	23.5	2.5	4.3	20.3	3.3	18.7

Data Source: Bloomberg. Base for Counter Cyclical and Pro Cyclical Calculation is Nifty 50. Above is only for illustration purpose. Past performance may or may not sustain in future.

As the table illustrates, a pro cyclical approach tends to do extremely well when markets are trending – either significant bull runs (2017) or bear runs (2008, 2011), because identifying the trend allows it to protect downside significantly in bear markets and also keep equity exposure high in trending bull markets. In more flat markets, where trends are clear, a counter cyclical approach will deliver similar results.

While at Edelweiss, we choose to follow the pro-cyclical approach in our flagship Balanced Advantage Fund, we do believe, regardless of approach, dynamic asset allocation is a powerful construct for investors and advisors. In providing the benefits of wealth creation while limiting downside, it will be a powerful strategy in navigating volatile times, particularly this VUCA financial year. As always, happy and peaceful investing, and thank you for your support!

Regards,
Radhika