Asset Allocation

Background

Asset allocation is one of the most important decisions that an investors makes. In other words, selection of stocks or bonds is secondary to the way one allocates their assets to high and low-risk stocks, to short and long-term bonds, and to cash on the sidelines.

What is good for one investor may not be so for another. An ideal portfolio depends on an investor's risk appetite, cash flow requirement, goals, and the investment's liquidity and tax efficiency.

Unfortunately, many investors start investing without determining their goals and the right asset allocation. Here's a look at basic concepts and strategies to help you while investing.

What is asset allocation?

- Asset allocation is a strategy which allows an investor to diversify his/her investment portfolio by investing in various asset classes such as equities, debt, real estate and commodities; according to investor's risk profile, investment horizon and financial goals.

- Asset allocation, when done sensibly, doesn't allow poor performance of any one asset class hamper the overall investment performance.

- Asset Allocation can be done in different manner; either by opting of existing Asset Allocation Mutual Fund schemes or managing the entire portfolio on your own with help of an financial advisor.

Why asset allocation?

- All asset classes have their varying cycles and perform differently in different market and economic conditions
- In other words, returns from different asset classes do not always move in tandem
- For instance, inflation which can be a negative for stocks in the short-term, could actually lead to a rise in gold prices (as investors tend to move from currency denominated assets to 'real' assets)
- Therefore a prudent asset allocation helps minimize the risk and enhance the overall portfolio returns

***5 Year Rolling Returns calculated form 3/1/2000 to 16/12/2013**

- A negative correlation has been observed between Nifty index and the 10-yr G-Sec during 2008-2009 and during 2012 periods. While, Gold is seen to have a negative correlation with both equity and debt at times

Benefits of Asset Allocation:

- Lower investment risk: the overall returns are not limited only to one risky asset, but rather a basket of both risky and non-risky asset classes
- Protection from Market volatility: a well diversified portfolio will provide protection and offer growth even during times of market crisis or during turbulent times
- Reduces dependency on single asset class
- Makes timing the markets irrelevant

Asset Allocation Strategies

Static Asset Allocation

- It is a passive investment strategy wherein the initially established asset mix ratio remains the same throughout the investment horizon. In other words it's more of a 'buy and hold' kind of strategy.
- It is a traditional approach of asset allocation, as it does not take advantage of market conditions and leaves significant portions of the portfolio vulnerable

Tactical Asset Allocation

- Also referred to as dynamic asset allocation is an active investment approach where in the distribution of assets is adjusted on a continuing basis in response in order to take advantage of changing market cycles, performance and outlook on various asset classes, availability of new & attractive investment opportunities in/out of the asset classes.
- To make the most out of this strategy the portfolio needs to be reviewed on a regular basis.

Points to Remember

- Risk Tolerance is an investor's ability and willingness to take risks to achieve the desired results
- An investor with high risk tolerance (aggressive) can skew his/her portfolio more towards the risky asset class like equities. Similarly, if the investor is willing to take relatively low risk (conservative), the portfolio can be skewed more towards fixed income instruments. And if the investor is a moderate risk taker he/she can take a mix of equity and debt respectively
  (Giving hyperlink to model portfolios / risk tolerance)
- **Time Horizon** is the expected number of years one would be investing for. An investor with a longer time horizon would generally have the capacity to invest in riskier or more volatile asset classes as he can wait out the inevitable market ups and downs
- **Review and Rebalance** is necessary at regular intervals, because over time some of the investments may become out of alignment with the investment goals or may have underperformed
- For instance, if portfolio maintains 60% equity allocation, but after a recent stock market increase, equity investments increases to be 80% of the portfolio; one needs to either sell some of the equities in order to reestablish the original asset allocation mix

Asset Allocation via mutual Funds

- Indian MF industry offers various asset allocation funds that can simultaneously invest in equity, fixed income and gold (via the ETF route)
- Fund Manager decides the allocation to be made to each asset class within the broader limits mentioned in the scheme information document
- These funds can churn their corpus across asset classes as per the changing economic conditions. i.e. the fund manager can shift money towards equity, debt or cash depending on the outlook for the markets and particular asset class
- In other words, such funds offer a one stop-shop for asset allocation

Individual Asset Allocation Strategies

- It involves an appropriate allocation of individual's wealth with help of an astute financial advisor which will generate adequate returns to meet the financial goals
- Advisor can help the investor with assessing his/her risk tolerance and time period and derive a suitable investment strategy which will help him/ her in achieving their financial goals

Funds v/s Strategies

Asset Allocation Funds	Individual Strategies
Tax Efficient: Debt Funds Taxation is applicable	**Taxation:** Applicable pertaining to each asset class
Cost effective: Only fund expense ratio is applicable	**Cost Consuming:** Fund expense ratio, Financial advisor fees, etc
Funds are not aligned with the investor's financial goals	Portfolio is aligned to achieve investors financial goals taking into consideration all the above mentioned parameters
Asset Allocation is done only on the Fund House's view and decision	Asset Allocation derived taking into account investor's attributes also

Conclusion

Asset Allocation can be an active or passive process. Choosing an appropriate asset allocation strategy and conducting periodic reviews will ensure you maintain client's long-term investment goals and reach client's desired return at the lowest amount of risk possible

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