Asset Allocation: The key to investing

In the process of personal financial planning an individual must select assets that will generate adequate returns to meet the financial goals, and at the desired levels of risk. This is known as asset allocation. Go through our Risk Analyser to learn what your asset allocation strategy should be.

Though "asset allocation" decisions are critical to one's financial plan, it is one that very few understand and consciously keep in mind when making an investment decision. There are two questions to be answered in every asset allocation decision: WHAT and HOW?

WHAT?

Asset allocation decision is about dividing the investments between asset classes such as equities, cash and money markets equivalents, bonds, insurance, real estate, derivatives. Commodities, antiques and art, international financial instruments.

The principal reason for diversifying investments across different asset classes is to minimize the risk of a portfolio. It requires one to avoid investments whose returns tend to move too closely with each other. Given this, the common flaw with investing in "growth stocks", "value stocks", "small caps" and "mid caps" is that their returns are all highly correlated, making them all members of the same asset class, "domestic equities". Similarly, "RBI relief bonds" are just one type of all the fixed income securities that are available to an individual, akin to Government of India securities like treasury bills and bonds, corporate bonds, certificate of deposits etc. While all these are fixed income instruments, they can still be divided into three asset classes viz. cash and money market equivalents like commercial papers, treasury bills etc., inflation-indexed bonds (that provide protection against inflation) and investment grade bonds (GOI as well as corporate bonds).

Another asset class that many do not consider is life insurance. It must be noted that life insurance should be considered as a unique asset class in itself, given that it creates an asset in case of an eventuality like death or disability of the individual. This ensures that the goals are met for the individual if he/she is present or for dependants in his/her absence

HOW?

Once an individual has identified these asset classes, he/she needs to know how to divide his/her investments in these asset classes. The key considerations in choosing the asset classes are the level of return and the risk. Liquidity, transaction costs and ease of investment are the other considerations. To keep it simple, some investors may prefer to look at it as balancing the downside (protection against capital loss) with upside (potential for high returns), which is not entirely correct but a useful way to look at investments. For instance, bank deposits may seem to provide a complete protection against capital loss. This is not true as in highly inflationary times, the deposits made at lower rates may not provide returns adequate to even beat inflation. This means that the capital value reduces in real terms even though in nominal terms that is not the case.

Also, research has shown that in general, people are more sensitive to losses than they are to gains of the same magnitude.

The factors that one should consider in choosing exposures to different asset classes are as follows:

1. Risk Tolerance : The degree to which one can tolerate risk varies for different people, and depends on the following:

Stage in life: A younger person, having a safe livelihood and few dependents, has time on his/her side can take more risk while choosing a portfolio.

Net-worth: If one owns lot of assets and have few liabilities i.e. have a high net worth one can afford to take more risk as one has a cushion of assets that can safeguard one from short-term losses occurring in due to market fluctuations.

Experience with investments: If one has prior experience in investing in financial markets and one is comfortable with short-term fluctuations then one can take more risk and hence more exposure to equity/real estate.

2. Investment objective : This entails deciding the purpose for which the investments are being made. Different objectives would demand that one tailor their investment portfolio to meet these goals. Objectives could be:

A person nearing his/her retirement would want a regular stream of income from the investment, while preserving the capital value, and should hence choose a safer portfolio.

If one is looking at growth along with preservation of capital, and is investing for a goal that is very important, such as saving for one's child's education, then one can take some more risk in pursuit of higher returns, but not at such a high risk that it might erode one's capital.

If one is looking at high growth and investing for a goal that is not very important then one can afford to take more risk.

3. Time Horizon : The time for which one would like to hold an investment also impacts the level of risk that one can undertake. If the goal for which the investment is being made is occurring after a long time, then one can pursue higher returns by investing in a more risky portfolio as over the period of time the risk reduces. However if one needs the money in the near future then one must invest in a safer portfolio. For instance based on historic data for SENSEX, the chance that an individual would suffer capital loss over a 10-year period is 1.5%.

Once an individual has decided on his/her asset allocation, the next step many ask is which securities within those asset classes one should select, and whether one should change the allocation from time to time based on market conditions.

The simple, clear answer is -- No!

Research studies conducted from time to time have shown that over a longer period of time (about ten years), one attains very little or nothing by market timing and security selection as far as portfolio management is concerned.

An investor must maintain discipline while managing these investments. Once he/she has determined the asset allocation, he /she should implement it using funds rather that direct purchase in the markets as it may be inefficient even when an individual has the access and ability to do so. Thereafter he/she should not succumb to the temporary blips in performance of various asset classes, and should instead use the concept like Rupee Cost Averaging.

http://www.ipers.org/calcs/AssetAllocator.html

http://fulcrum.com/allocation.htm