On your investment journey, keep the diversification compass well balanced

Diversification in a portfolio spreads the risk at two levels—among asset categories and risk from product manufacturers

Last Published: Wed, May 16 2018. 08 11 PM IST

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For Shweta Shankar, a Bengaluru-based IT professional in her early forties, real estate was the primary asset of choice soaking up nearly all her net worth, save the customary fixed deposits she had for any surplus cash. Investments in realty, she believed, are safe and a reliable long-term wealth creator; an ideal choice for her family's future.

However, asset prices and returns change over periods; over-allocation to one asset can be disadvantageous. Bank fixed deposits, for example, offered 9% on a 1-year deposit back in 2014; today you get only around 6.5-7% for the same. As is evident with recent residential real estate prices across big and small cities in India, it's hard to tell when a price correction might come or how long it will stay.

"It's only after our adviser came into the picture that we realised there are potentially higher and more stable returns to be made in the long term if we have a diversified portfolio. Ultimately, we have arrived at a goal-driven portfolio and it's a mix of equity, fixed income and also some real estate," said Shankar.

Swetha Shankar, Bengaluru-based IT industry professional; Photo: Nagesh Polali/Mint

Diversification is a concept that's now being understood and implemented better. With more awareness around goal setting and long-term wealth creation, well thought out asset allocation gains significance.

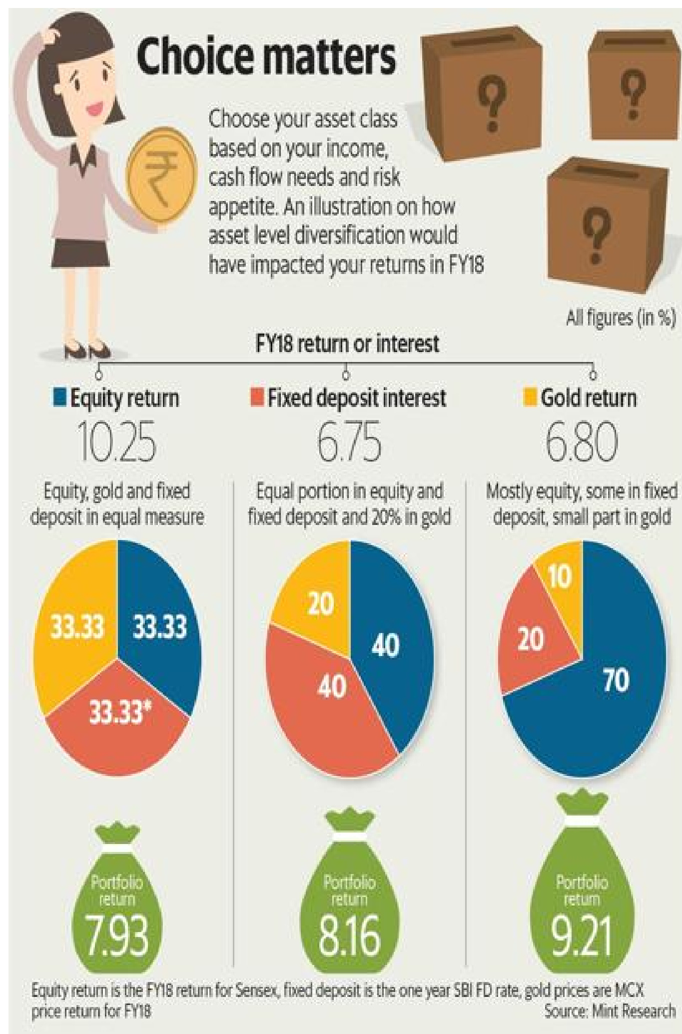
What does it mean?

Diversification takes shape at least at two levels. First, you must have a mix of different assets like equity, debt, real estate and gold. Then, within each asset class, have a mix of products. While the former will spread your risk if one asset is in a downcycle, the latter will help you spread the risk of just one product manufacturer, be it an asset manager, bank or even a real estate company.

Add to this the difference in characteristics such as liquidity and taxation, it is inefficient to have only one type of asset in your investment portfolio. Shankar initially started diversifying by making fresh investments in equity mutual funds. Eventually, when real estate investments were sold, that money too was reinvested partly in mutual funds.

Kavitha Menon, a Mumbai-based financial planner, said, "Many people have biases. Keeping all your money in a savings account because you can see it grow, means losing out on higher returns in a liquid fund. Money locked up in real estate is illiquid. When it comes to an urgent need for cash, you have to borrow or take personal loans."

At an asset level it's your income, cash flow, risk appetite and future financial needs that will determine the allocation, she added.



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How to diversify?

Amit Tyagi, a 46-year-old professional starting his own venture in the F&B industry, was not new to investing when he met Anup Bansal, managing director, Mitraz Financial Services Pvt Ltd. Tyagi's then investment profile had a 66% deviation in asset allocation compared to the ideal level that was discussed with Bansal. However, both Bansal and Tyagi took forward the process of changing the allocation over a period of time and four years later, the deviation stands at 33%.

“Whatever I used to invest in earlier, the portfolio return didn’t cross 10% on average. Now we are earning around 13-14% despite volatility, thanks to a good mix of products,” said Tyagi. His portfolio has a mix of 7-8 mutual fund schemes and there is a detailed analysis reasoning a change each time it’s recommended. He also invests in Public Provident Fund (PPF), fixed deposits and Sukanya Samriddhi account to maintain a balance that is in line with his investment profile.

Stocks and bonds represent earnings and cash flows of companies. It is hard to ascertain beforehand if there will be lapses in, say, corporate governance (Gitanjali Gems, which once traded at Rs600, is now at Rs4.20 after corporate governance lapses came to light), or the demand environment, or technological innovation which can ultimately impact earnings, cash flows, stock prices and bond payouts negatively.

However, diversification doesn’t mean adding a new security each time. Menon cautions, “A portfolio of stocks means you have to track the financial health and corporate action of each. It’s hard to manage with more than 15-20 stocks.”

Amit Tyagi (46), professional turned entrepreneur; Photo: Nagesh Polali/Mint

Although, as Tyagi was quick to admit, the lure of higher returns is sometimes hard to resist, “Every once in a while, I tend to push for a product where we can get a higher return, only to be told firmly that jumping from one to another product chasing returns isn’t going to help in the long run,” he said.

There is no incremental advantage in overdiversifying. Bansal gave an example to explain this. “Let’s assume you invest Rs100 in 50 stocks of Rs2 each. If one stock doubles, your gain is Rs2 or 2%. Now contrast this with a portfolio of 20 stocks of Rs5 each. If a stock doubles, your gain is 5%. Over-diversification can happen when you get tips from others and are yourself aware where to invest, you end up with small amounts invested in many securities or products.” The same applies to holding managed products in different asset classes. If you hold five equity diversified funds, you can potentially have 150-200 stocks in your portfolio.

“Often, people diversify their fund manager risk by adding different mutual funds, but (in doing so) there could be a lot of stock or security overlap. Ideally, you don’t need more than five equity funds in the portfolio,” said Vishal Dhawan, founder and chief executive officer, Plan Ahead Wealth Advisors.

Starting your investment journey with adequate diversification not only helps preserve returns but also ensures that you have allocated to assets as per your financial objectives.

First Published: Wed, May 16 2018. 08 25 AM IST

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