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Why a permanent portfolio is a good option for passive investors

By *Narendra Nathan*, ET Bureau | 11 Apr, 2016, 08.00AM IST

A permanent portfolio allocates 25% each to equity, debt, gold and cash. Our 15-year study shows that it delivers returns comparable with equities and is best suited for passive investors.

It is generally accepted that asset allocation should be based on several factors— investor's age, risk appetite, risktaking ability, time period and importance of goals. It is difficult for retail investors to arrive at the correct asset allocation without professional help, because they have to take into account all these factors. "While a 25 year old who gets financial support from family can have an aggressive asset allocation, another who has to support his family has to be conservative," says Vishal Dhawan, CEO, Plan Ahead Wealth Advisors.

There are also experts who suggest that you need to change your asset allocations based on broader market valuations- increase equity allocation when market valuations are down and reduce it when valuations go up. Since markets, Indian market in particular, are highly volatile, it becomes difficult for investors to change their asset allocations on a regular basis.

To solve the problem of retail investors not keen on seeking expert guidance to manage their portfolio, investment analyst Harry Browne, in his book Fail Safe Investing, came up with the idea of a 'permanent portfolio'.

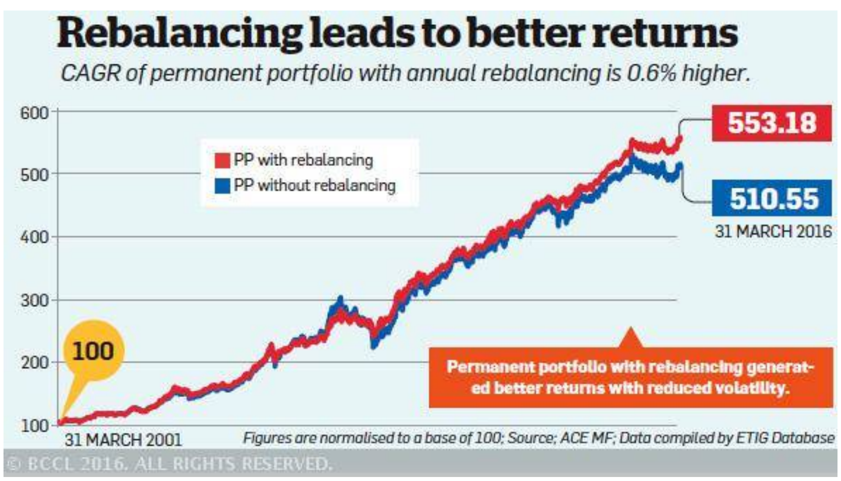
A permanent portfolio comprises equities, debt, cash and gold. While portfolio diversification is common knowledge, what differentiates a permanent portfolio is its simplicity. Instead of deciding how much to invest into each of these four asset classes, a permanent portfolio invests equal sums, 25% each, in all of these. A permanent portfolio comprises the mentioned asset classes because they behave differently during market cycles.

With a standard deviation of just 7.5%, permanent portfolio offers the best risk-adjusted returns. See chart below:

So, while some may outperform in a particular cycle, others may underperform. The diversification thus tends to offset volatility in portfolio returns. For example, equities will gain during an economic boom and crash during a recession. Similarly, long-term debt will generate decent returns during recession and will generate fabulous capital gains when rates start falling.

Cash or liquid funds will generate reasonable returns across time period, but may generate better return during periods of tight monetary policy and also when short-term rates move up. While gold offers protection against inflation in the developed markets, it acts as a protection against currency depreciation in the developing economies such as India.

Brown's book, which came out in 1999, has generated substantial investor interest and several studies in the Western markets have concluded that a permanent portfolio may be enough for most retail investors. But, will the concept work in Indian markets? Experts are not very gung-ho about it. "Equal weight to all asset classes reduces weight-to-growth assets like equities," says Dhawan of Plan Ahead Wealth Advisors. "From the asset allocation perspective, 25% equity allocation will work only for conservative investors. Gold allocation shouldn't be more than 10%, and that too for long-term portfolios," says S. Sridharan, Head of Financial Planning and Advisory, FundsIndia.com. Even as experts have been critical of the idea, we decided to do some empirical research to test the permanent portfolio's value in Indian markets.



Back testing

In our study, the Sensex was used as a proxy to represent equities. Dividend yield was not considered as investors opting for mutual funds incur expense ratio which nullifies the small dividend yield. Longterm gilt funds were used as proxy for longterm debt. We selected the top three schemes, which have been in operation for at least 15 years, in terms of their assets under management. The gilt portfolio return was arrived at by assuming that the investor has put an equal sum in all three gilt funds. We selected liquid funds and calculated the returns for the liquid portfolio in a similar way. However, all three liquid funds have moved in tandem and generated almost the same returns.

The next step was to use a proxy for gold. Gold funds and gold bonds are the best alternatives for this, but neither have a 15-year track record. While there is a small expense ratio for gold funds and actual return will be less than gold price gain, gold bonds generate a small interest and actual return will be more than the gold price gain. So, we have considered absolute gold prices for this study—no reduction for expenses or addition for interest income. Our back testing confirmed most theoretical assumptions. Long-term gilt funds, for instance, countered the impact of massive equity correction phase of 2008-09. For example, ICICI Pru Long Term Gilt Fund (G) generated a return of 23.36% during the 2008-9, when the Sensex generated a negative return of 37.94%. Similarly, gold too saw a massive rally and generated a return of 24.58% during the same period.

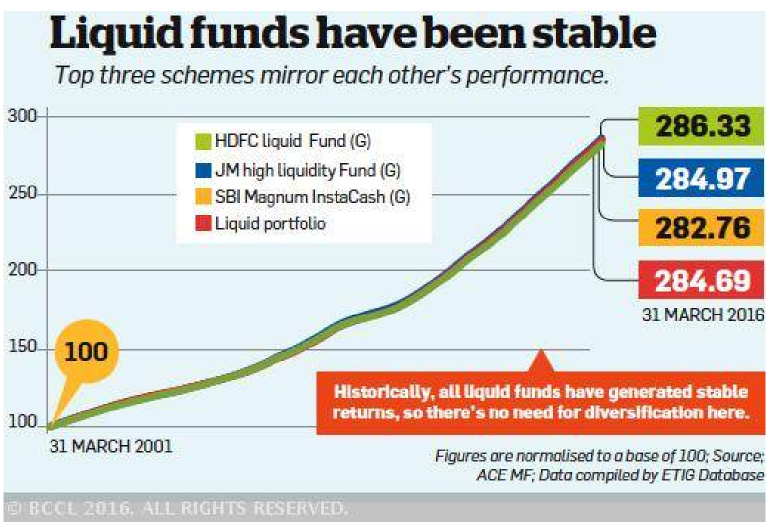
Traditional Indian investors still swear by gold as a long-term asset and they have a valid reason to do so. Gold has seen a compound annual growth rate (CAGR) of 13.66% in the last 15 years, only slightly lower than the Sensex return of 13.97%. More importantly, this comparable gold return came at a significantly low volatility — gold's standard deviation was only 16.62 compared with 24.35 of the Sensex. However, gold may not generate this kind of return in the coming years. This is because the rally in international market is almost over, and gold's future return will be more linked to rupee depreciation.

Permanent portfolio types

The permanent portfolio can be of two types. In the first one, you invest fixed proportions, 25% each in the four asset classes, and stay invested in them for a very long time. You can also make use of SIPs for such an investment. In the second case, you rebalance the portfolio on a regular basis. When should one do the rebalancing? "Annual rebalancing is enough for most portfolios, but if the investor wants to be aggressive, he can go for a sixmonth rebalancing," says Dhawan. "While annual rebalancing is the norm, you can also rebalance every three years, if the investment horizon is very long (say, 30 years)," says Shankar Raman, CIO, Third Party Products, Centrum Wealth Management. For this study, we have calculated the return and risk for both types of portfolios. For the rebalanced permanent portfolio, we have gone for annual rebalancing—on the last trading day of every financial year.

A rebalanced portfolio has generated better returns: a CAGR of 12.08% compared to non-rebalanced portfolio with a CAGR of 11.48%. Additionally, a rebalanced portfolio also drastically reduced volatility in returns. For instance, the annualised standard deviation of rebalanced portfolio was only 7.48, compared to 9.54 for the non rebalanced portfolio. Annually balanced permanent portfolio has done well during the last 15 years, so it should serve the needs of most retail investors. Its CAGR of 12.08% may be slightly lower than that of the Sensex's CAGR of 13.97%.

However, a permanent portfolio will be the winner if you consider the risk-adjusted returns of both. This is because at 7.48, the standard deviation of a permanent portfolio is very low compared with that of the Sensex—24.35. Finally, while the option of a permanent portfolio provides ease of investing, you cannot be reckless. "Investors need to pay attention to the choice of product under each asset class, else rebalancing will become difficult," says Dhawan. For example, investing into illiquid stocks or equity funds with withdrawal restrictions— ELSS, child plans, etc.—can make the rebalancing impossible. Similarly, on the debt side, one needs to avoid products such as EPF, PPF, etc. that come with restrictive clauses.



(*Figures are normalised to a base of 100; Source; ACE MF; Data compiled by ETIG Database*)

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