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These portfolios can be forever

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It is accepted that asset allocation should be based on several factorsinvestor's age, risk appetite, risk taking ability, time period and im portance of goals. It is difficult to arrive at the correct asset allocation without professional help. "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. Some experts say you need to change asset allocations based on broader market valuations-increase equity allocation when market valuations are down and reduce it when valuations go up. Since markets are highly volatile, it becomes difficult for investors to change asset allocations on a regular basis.

To solve the problem of retail investors not being keen on seeking expert guidance to manage portfolios, 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 in each asset class, a permanent portfolio invests 25% in each.

A permanent portfolio comprises the mentioned asset classes because they behave differently during market cycles.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.

Following the publication of Brown's book, several studies in the West 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. "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. We decided to do some empirical research to test the permanent portfolio's value in our 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 dividend yield.Long-term gilt funds were used as proxy for long-term debt. We selected the top three schemes, which have been in operation for at least 15 years, in terms of 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 liquid portfolio in a similar way. However, all three liquid funds have generated almost identical returns. The next step was to use a proxy for gold. Gold funds and gold bonds are the best alternatives, but neither have a 15-year record. So, we have considered absolute gold prices for this study.

Our back testing confirmed most theoretical assumptions. Long-term gilt funds, for instance, countered the impact of massive equity correction of 2008-09. 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%.

Gold too saw a massive rally and generated a return of 24.58% during the same period. Gold has seen a CAGR of 13.66% in the past 15 years, slightly lower than the Sensex return of 13.97%. 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 coming years.

Permanent portfolio types

Permanent portfolios can be of two types. In the first, you invest fixed proportions, 25% each in four asset classes, and stay invested for a long time. In the second case, you rebalance the portfolio regularly. 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 six-month rebalancing," says Dhawan.

We calculated the return and risk for both types of portfolios. For the rebalanced permanent portfolio, we went for annual rebalancing. A rebalanced portfolio generated better returns: a CAGR of 12.08% compared to non-rebalanced portfolio with a CAGR of 11.48%. 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 re-balanced portfolio.

Annually balanced permanent portfolio has done well, so it should serve the needs of 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 riskadjusted 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.

While the option of a permanent portfolio provides ease of investing, you cannot be reckless. Investing into illiquid stocks or equity funds with withdrawal restrictions 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.