In correction time, spread your risk

— Vishal Dhawan —

With equity markets currently close to 52-week high and an increasingly bearish view on the global economy, there has been a marked slow down in equity investments by individual investors over the last few months in anticipation of a correction.

However, this correction has not been forthcoming, leaving a large number of frustrated investors waiting on the sidelines.

In this backdrop, we believe that the investment strategy of individual investors may need to be adjusted to the new environment through the use of different investment strategies. While some of the strategies can be implemented by investors themselves, some of them may require professional advice for which it may be prudent to use a financial planner.

Financial goal based strategies

Empirical evidence indicates that stock market returns tend to be very concentrated with an abnormally large percentage of total returns being generated on a small percentage of days. Therefore, market timing strategies may need to be used in a restricted manner. It may be more prudent to decide allocations to equities basis residual time for realisation of goal.

For example, if there are two years to go before money is required for your child's education, it would be prudent to be in fixed income instruments, while if there are 10 years to go before you require the money, it would be a good idea to allocate funds to equities right away and reduce exposure as you get closer to the goal.

Investors can consider the use of Systematic Transfer Plans (STPs) wherein the funds are parked in fixed income initially

Dynamic asset allocation

Since equity markets tend to move up and down on the basis of greed and fear, a scientific process of deciding how much money needs to be allocated to equities can take the emotion out of the investing process.

This strategy can either be implemented on the portfolio by oneself, or alternatively there are products available with track records that decide the mix of equities and debt basis equity market PEs. Thus, when PEs are higher which indicate that equity markets are on the higher side, they have lower exposure to equities and as PE go down, they increase exposure to equities as equity markets have become cheaper.

Use of regular investing strategies

While regular investing has become popular over the last few years with the advent of SIPs in mutual funds, the key to success in this strategy is to ensure that the investments continue when equity markets move downwards as your average cost of purchase gets lowered during this phase. During the last market correction, a large number of investors stopped their SIPs, instead of increasing them. As a result, the true benefits of a SIP did not get transferred to the portfolio returns. For investors with existing lump sums of money available, they can consider the use of Systematic Transfer Plans (STPs) wherein the funds are parked in fixed income initially, and then moved to equities gradually over a pre-determined timeframe. Investors could also consider the use of a value averaging strategy that increases investments when markets fall, and decreases investments when markets go up.Investors could also consider using strategies that focus on buying stocks that have high dividend yields, which tend to protect the downside better when markets fall even though they may underperform while markets go up.

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