

Business Today

Right Asset Mix is Key to Riches

By Vishal Dhawan

A large number of investors are looking to identify the best asset class to be in for now. The aim is to move in and out of asset classes in a swift manner, so that they can generate highest returns, with minimal risk. The challenge is that most do not get this right, and thus set themselves up for disappointment.

Most investors at the end of March 2020, for example, would not have believed that global equity markets will be close to their all-time highs in just a few months, despite the biggest lockdown in the history of the world. Thus, having a well-defined mix of assets, put together scientifically, is critical for long-term investment success.

In order to decide the right mix of assets, or asset allocation, as many technically refer to it, clarity on a few things could be of significant value.

Define Goals with Timeframes

It is critical to start with a set of clearly defined goals at the outset, so that it is easier to look at asset classes suited to those needs, rather than constantly chasing the best asset class in terms of returns. A typical set of financial goals for a 35-year-old may include having a self-owned house by 40 with a manageable mortgage, an education corpus to support overseas education for children by the time they turn 18 and comfortable retirement without compromising the retirement age. By clearly understanding what investment time horizon you have before you need money to achieve your financial goals, you are in a better position to choose asset classes and, therefore, the mix. For example, asset classes like equity, gold and real estate that have the

ability to beat inflation over long periods can be very volatile in the short term, and thus are ideally suited for goals that are long-term in nature, that is 10 years-plus away. In contrast, debt as an asset class is suited to short-term investments, that is, between one and 10 years away.

Understand Risk Tolerance

The cycle of greed and fear can cause investors to take on much more risk than they are comfortable with, or become far more conservative than they need to, when financial markets are doing extremely well or giving negative returns, at different points.

Very often, we find the reason for this is that investors may have a very different risk tolerance from the portfolio that they have chosen to create. A well-designed risk tolerance questionnaire, along with an understanding from past data on how financial markets behave both when they do well, and also when they are down, can help investors better understand how much downside they can withstand before they start to worry about their investments and possibly make mistakes. The asset allocation may vary depending on their risk tolerance, which could vary from conservative and moderate to aggressive. Investors who have a conservative risk tolerance are more likely to deal better with higher exposure to debt as an asset class, with some exposure to equities and gold. In contrast, investors with a moderate risk tolerance can look at a blend of debt, equity and gold, while investors with an aggressive risk tolerance can look at a larger exposure to equity, real estate and gold in the portfolio.

Correlation Among Assets

Over long periods of time, you will find that the correlation among equities, debt and gold is very small, and thus they combine well together to ensure that your portfolio does not all move up or move down at the same time. Adding international equities into the portfolio could further diversify your portfolio and make it more robust from asset class cycles that are inevitable over a period of time.

While a robust asset allocation strategy can seem rather theoretical, we find that it has great application in real world outcomes. For instance, Rajesh and Priya (names changed on request) came to meet us about five years ago seeking an aggressive portfolio to help them achieve their retirement objectives faster, on the back of a strong outlook for India. This desire was fueled by a relatively recent change that had happened in the government in power and great excitement about the India story on the back of multiple reforms that were expected to transform India into an economic giant. This was also backed by a global growth story that was starting to gather momentum, and they wanted to use this opportunity to accelerate their plan for financial freedom.

When we ran them through a risk tolerance tool and discussed portfolio return ranges both on upside and downside, we discovered they were not comfortable with their portfolios going below a certain threshold, even if it was temporary. Thus, the right portfolio mix that would have worked for them was more in line with a balanced portfolio, and not an aggressive portfolio they would have conventionally created for themselves. We could sense a tinge of disappointment at the outset with the portfolio that was created for them that has a blend of domestic equities, international equities, gold and debt funds, against a conventional portfolio that they wanted to create which was completely Indian equity centric.

As we look back at the comparison of their multi-asset balanced portfolio after five years, as against a 100 per cent domestic India equity portfolio that they wanted to ideally create, the balanced portfolio has delivered a return that is approximately 3.5 per cent per annum higher with volatility, measured by standard deviation, at approximately one-third. We also looked at conventional portfolios for conservative, balanced and aggressive investors, and found that multi-asset portfolios tended to outperform their conventional counterparts over the last five years, and for shorter tenures as well. While this outperformance may or may not continue in the future, our experience shows that having the right asset allocation can help you achieve your financial goals, and in turn sleep better at night.

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