An Investor Education Initiative
Mirae Asset Mutual Fund
by Mirae Asset Knowledge Academy

ASSET ALLOCATION

THE KEY TO HELP IN YOUR FINANCIAL SUCCESS

Introduction

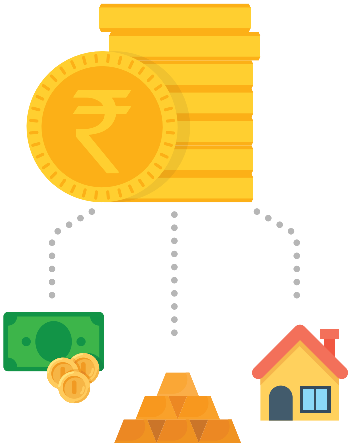
If you have an opportunity to make your own team in IPL, what will you do? Take all the best batsman or make a team of all types of bowlers or make a good mix of batman's, bowlers and fielders.

To win a match it is important to have good mix of players with different skill sets. Similarly, in your portfolio you need all kind of asset classes, which will perform in different market conditions.

A good team mix can be a mantra for winning a match and asset allocation can be a mantra for a winning portfolio.

What is asset allocation?

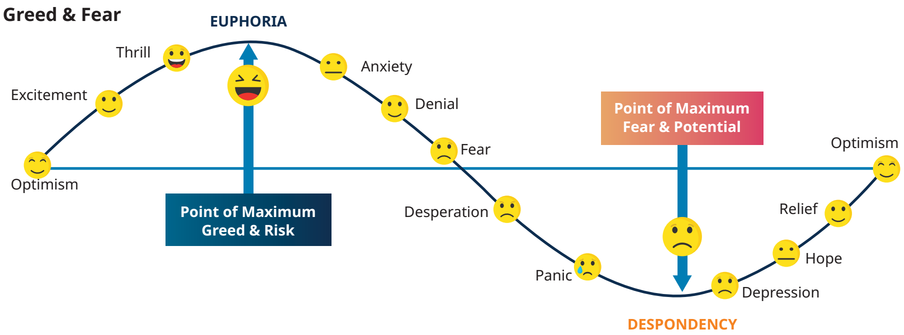
Asset allocation is the mix of **different asset classes** e.g. equity, debt, gold etc. in an investment portfolio. The aim of asset allocation is to **balance risk** and **returns** in accordance with different **financial goals** and **risk appetites.** Unfortunately, asset allocation is not given its due importance by many investors in India and we see investment portfolios heavily skewed towards particular asset classes without factoring in risk and return consideration.



Why is asset allocation important?

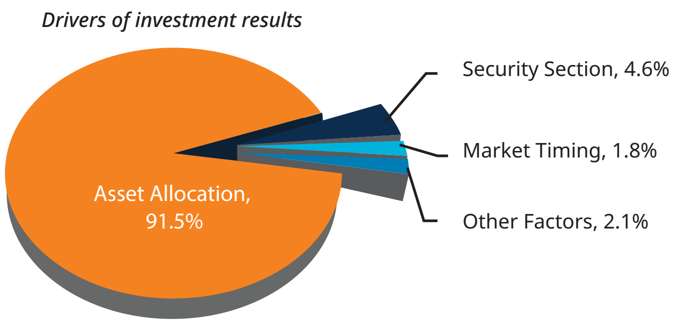
Risk and returns are directly related but risk is a double edged sword. If you take too little risk, you may not be able to make the money needed for your financial goals. On the other hand, if you take too much risk, you will expose your financial goals to uncertainties of capital markets. Right asset allocation means that you take the optimal amount of risk to meet your short term, medium term or long term financial goals.

1 **Irrational** behaviour is very common in investing because **greed and fear** plays a big role in how we invest. When the market is high, people put more and more money in stocks expecting market to go even higher. When the market is low, people sell stocks fearing market to go even lower. Such irrational actions harm the long term financial interests of the investors. An asset allocation based approach takes emotions out of investing and keeps you **disciplined**.



2 **Drivers of investment results**

We have seen that investors spend too much time on trying select best performing schemes. But historical portfolio returns analysis provides overwhelming evidence that asset allocation is the most important attribute of portfolio performance.



Source: Determinants of Portfolio Performance, published in the Financial Analysts Journal - 2005.

3 Winners keep changing

Different asset classes outperform / underperform each other in different stages of **investment cycles.** Asset allocation may ensure a degree of portfolio stability in different market conditions and may give good returns across investment cycles.

The below chart shows how various asset classes performed on year-on-year basis from 2004 to 2019

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Best	35%	62%	42%	87%	28%	107%	30%	10%	39%	7%	56%	9%	15%	57%	6%	18%
	25%	36%	40%	77%	9%	99%	19%	7%	37%	4%	55%	7%	13%	47%	6%	12%
	11%	35%	29%	55%	6%	76%	18%	2%	28%	-1%	31%	7%	8%	29%	3%	11%
	6%	18%	23%	31%	-52%	24%	18%	-25%	11%	-5%	14%	6%	7%	14%	-2%	10%
	0%	5%	5%	7%	-59%	4%	5%	-31%	9%	-8%	14%	-4%	3%	5%	-15%	-4%
Worst	-5%	4%	4%	6%	-71%	-9%	3%	-34%	7%	-28%	-1%	-10%	2%	0%	-29%	-10%

Large Cap Equity · Mid Cap Equity · Small Cap Equity · Long term G-sec · Corporate Bond · Gold

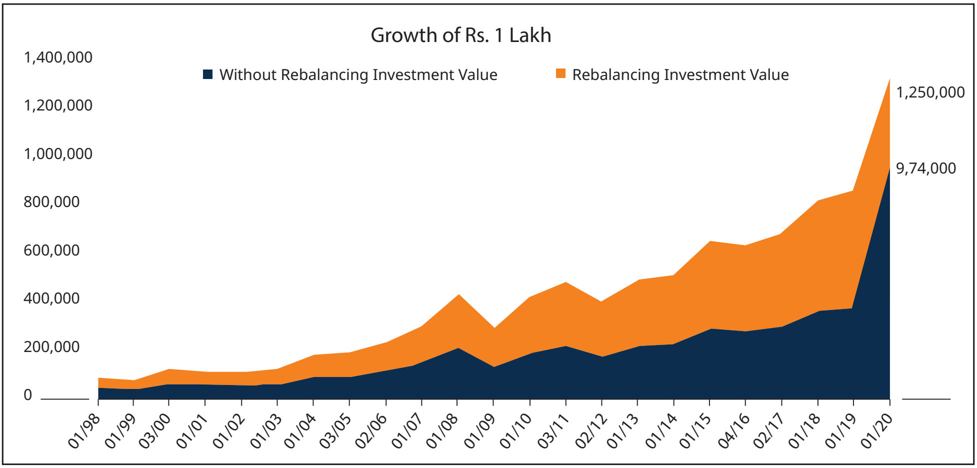
Source: Bloomberg as on 31st Dec 2019

4 Importance of Portfolio rebalancing

Different asset classes outperform / underperform each other in different market conditions; without rebalancing, your asset allocation can deviate significantly from your target allocation.

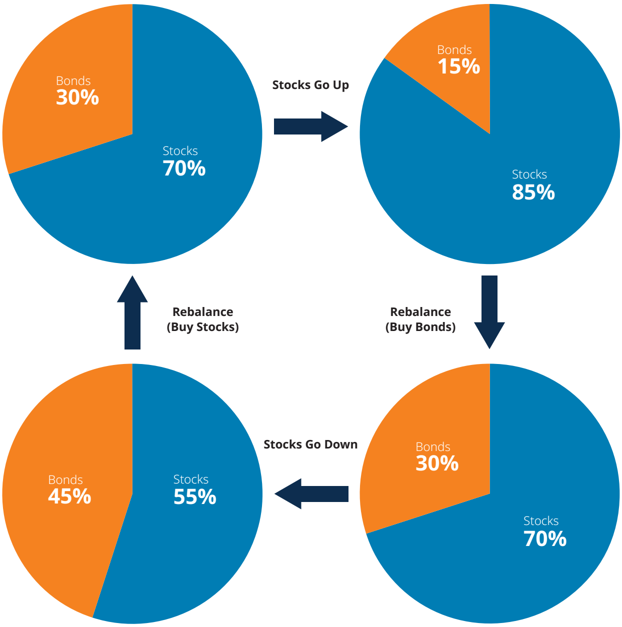
How does Portfolio Rebalancing happen?

Let us understand the importance of asset rebalancing with the help of an example. Let us assume you invested Rs 1 lakh in the proportion of 70% equity and 30% debt in 1998. In the first example, you only did a one-time asset allocation at the time of your investment. In the second example, you were rebalancing your portfolio every year to bring back the asset allocation to 70% equity and 30% debt. If equity allocation exceeded 70% equity any year, you sold equity and bought debt to keep asset allocation at your target. Similarly when equity allocation was below 70%, you sold debt and bought equity to keep asset allocation at 30%.



Source: Advisorkhoj, 31st December 2019

In these two examples, we will use Nifty 50 as the proxy for equity and Nifty 10 year G-Sec Index as the proxy for debt. Let us see how your investment would have grown over the last 20 years without any rebalancing. Your investment's market value at the end of 2019 would have been around Rs 9.7 lakhs. **However if you would have done annual rebalancing the value would have grown to 12.5 lakhs, an incremental gain of 2.7 lakhs.**



Types of Asset Allocation / Hybrid Funds

Aggressive Hybrid Funds

These funds have a static asset allocation strategy with the flexibility to keep its asset allocation within prescribed ranges mandated by SEBI. SEBI requires these funds to invest 65 – 80% of their assets in equity or equity related securities and rest in money market or debt securities. Aggressive hybrid funds follow a rigorous **rebalancing** process to keep their asset allocations within the prescribed limits. It follows a process to buy low and sell high and rebalance its asset allocation. As per our tax laws, mutual fund schemes which invest 65% or more of their assets in equity and equity related securities enjoy equity taxation.

Equity Savings Fund

Equity savings fund essentially aims to generate returns by investing in equity, debt and arbitrage opportunities. This last component sets them apart from other hybrid funds. Essentially, the fund manager looks to exploit the pricing inefficiencies in the cash and derivatives segments of the equity market. Thus, the fund's overall equity exposure is partially hedged, reducing its volatility as compared to an aggressive hybrid fund, where the equity exposure is fully unhedged.

Dynamic Asset Allocation Funds

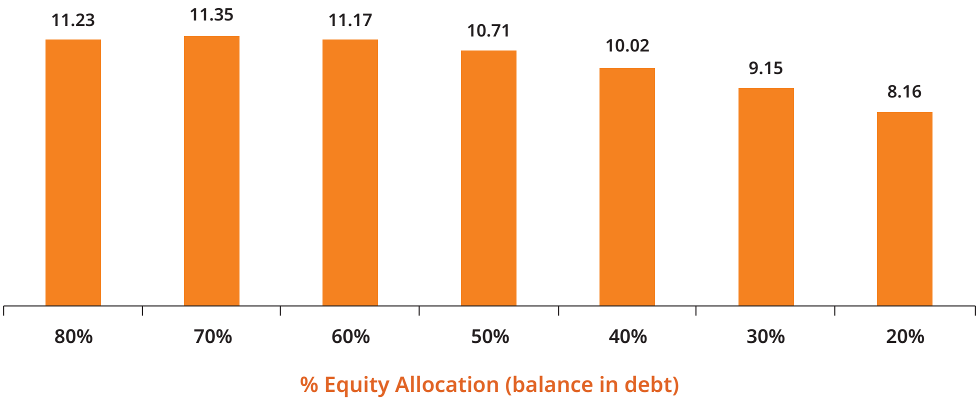
These hybrid funds also known as b**alanced advantage funds,** dynamically manage their equity and debt allocations. SEBI has no asset allocation limits for these funds; theoretically, they can invest 0 – 100% in equity or debt. Different fund managers use different valuation metrics for dynamic asset allocation, the most common being P/E and P/B ratios. The taxation for these funds can be impacted if the allocation to equity and equity related instruments is less than 65%.

Fund category	Asset allocation		Taxation
	Equity	Debt	
Aggressive Hybrid Fund	65% - 80%	20% - 35%	Equity
Conservative Hybrid Fund	10% - 25%	75% - 90%	Debt
Dynamic Asset Allocation / Balanced Advantage Fund	Investment in equity/ debt that is managed dynamically between 0-100%		Can be Equity or Debt, based on allocation
Multi Asset Allocation	Min 10% in all three asset class (Equity, Debt and Gold) mentioned in Funds SID		Can be Equity or Debt, based on allocation
Equity Savings*	Min 65%, including Arbitrage (unhedged Equity usually between 20-45%, remaining arbitrage)	Mini - 10%	Equity Fund Taxation (due to Arbitrage allocation)

* Hedging % to be defined in fund SID

Summary Points

Let us take an example to show market value (at the end of 2019) of Rs 1 lakh investment made in 1998 for different asset allocations with annual asset allocation rebalancing to the target asset mix. You can see that the maximum wealth creation has taken place in 70% equity and 30% debt asset mix.



Source: Advisorkhoj, 31st December 2019 (Nifty 50 as the proxy for equity and Nifty 10 year G-Sec Index as the proxy for debt.)

This analysis has several important lessons for investors:-

- The asset mixes in the above analysis gave double digit returns over the 20 year period. This shows that you can beat inflation with asset allocation.
- While risk and return are related, you need not take excessive risk to get the best results in terms of wealth creation.
- With asset allocation it is possible to balance risk and return to get superior absolute returns.
- The most optimal asset mix has been around 70% (equity). Hence from a long term perspective investors can look at Aggressive Hybrid Funds as suitable investment options.

MIRAE ASSET
Mutual Fund

An investor education initiative by Mirae Asset Mutual Fund.

All Mutual Fund investors have to go through a one-time KYC (Know Your Customer) process. Investors should deal only with Registered Mutual Funds (RMF). For further information on KYC, RMFs and procedure to lodge a complaint in case of any grievance, you may refer the Knowledge Center section available on the website of Mirae Asset Mutual Fund.

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.

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