Hybrid funds an able asset allocation ally

Toss a coin and there is only half a chance it will be heads. That goes for our investments as well – no single asset class, or sub-class therein, can outperform all the time, and so the winners will keep on changing.

Indeed, as depicted in the table below, the primary asset classes – equity, debt, gold – have seen the leaders and laggards trade places frequently over the past decade or so. Back in 2011, gold led the pack with a return of 32.12%, while equity turned in a 24.21% de-growth. Cut across 10 years to 2021 and we see that equity is leading with 12.74% returns, while gold has logged -3.15% de-growth as of July 30.

Asset class	Asset class calendar year performance (%)										
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021*
Equity	-24.21	27.70	6.76	31.39	-4.06	3.01	28.65	3.15	12.02	14.90	12.74
Gold	32.12	12.12	-4.43	-8.10	-6.69	11.66	4.85	7.83	23.88	27.97	-3.15
Long term debt	6.92	9.38	3.79	14.31	8.63	12.93	4.69	5.91	10.72	12.29	1.19
Short term debt	8.17	8.54	9.03	9.21	8.23	7.48	6.64	7.58	6.86	4.61	2.07

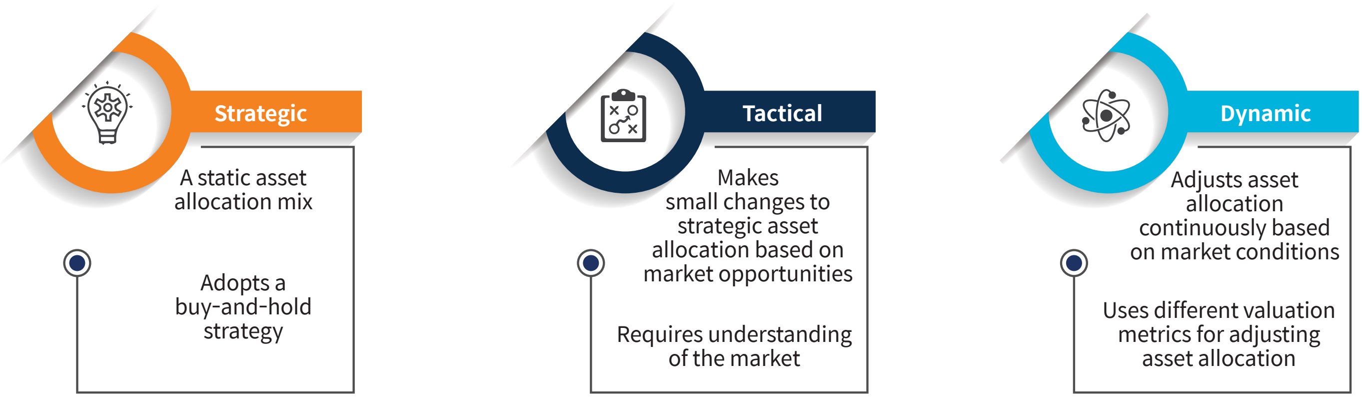
*Data till July 30

Green box denotes top performer in the period, while red denotes bottom performer among the asset classes Nifty 50, domestic gold prices, CRISIL Composite Bond Fund Index and CRISIL Liquid Fund Index has been used as proxy for equity, gold, long-term debt and short-term debt asset classes, respectively

It is thus nigh on impossible to predict the winner.

But that being the case, how should one go about investing? For one, allocating money across asset classes can help optimise returns, provided this is done based on an individual's risk-return profile and investment horizon. Ignoring the importance of asset allocation in tandem with risk appetite can significantly derail financial planning.

This is where hybrid funds help, as we will see later in this article. But first, a look at the different kinds of asset



For illustrative purposes

1. Strategic asset allocation

As the name suggests, the strategy followed is more strategic and long-term, with a static portfolio mix based on the investor's risk-return profile. The churn in the portfolio is done on a periodic basis, preferably annually, to remain in line with the mandated asset mix.

The investment strategy brings discipline as it is akin to a buy-and-hold strategy rather than one that sways with short-term market movements. The reduced churn also reduces the overall transaction and tax liability incurred from frequent overhaul of the portfolio.

2. Tactical asset allocation

This strategy builds on strategic asset allocation, but deviates slightly by making small changes in the portfolio based on changes in market conditions. In this strategy, the fund manager takes calls based on their investment expertise to alter the portfolio. Once the short-term market phenomena subsides, the allocation usually reverts to the original strategic asset allocation mix.

Tactical asset allocation not only works across asset classes but also within an asset class. For instance, in case the fund manager sees an opportunity within the small cap segment of equity, the manager may decrease the large/mid cap exposure and increase the small cap exposure and then revert to the intended asset allocation.

3. Dynamic asset allocation

As the name suggests, the strategy dynamically churns the portfolio based on market conditions. Usually to churn the portfolio, fund managers use valuation metrics such as Price to Equity (P/E), Price to Book Value (P/B) and Dividend yield as part of their investment strategy.

Additionally, investors also follow a contra strategy (opposite to the market) and pro-market movement strategy depending on their overall investment objective. Dynamic churn adds to the overall costs for investors in terms of transactions and taxation liability.

Stable asset allocation, a better ploy over the long term

While all three types of asset allocation have their advantages and disadvantages, strategic asset allocation with a periodic review is a better investment strategy for investors who are in the market for the long haul and their patience is reflected in the numbers.

For this analysis, we have compared the performance of the aggressive hybrid fund category with an equity exposure of more than 65% with a dynamic asset allocation fund category/balanced advantage funds. The latter also tends to have an exposure to equity between 65% and 100% but has the flexibility to move across the asset allocation spectrum through a higher exposure in debt and derivatives.

Market phase analysis

Market phase	Aggressive hybrid funds	Balanced advantage/ dynamic allocation funds
Eurozone crisis (Jan 2011-Jun 2013)	-0.25	2.16
Post eurozone crisis (Jul 2013-Feb 2015)	34.08	30.25
Chinese slowdown (Mar 2015-Feb 2016)	-12.62	-9.55
Global liquidity and domestic reforms (Mar 2016-Dec 2017)	24.34	18.90
1st wave of Covid-19 pandemic (Jan 2020-Mar 2020)	-20.76	-14.71
Recovery from Covid-19 pandemic (Apr 2020-August 9, 2021)	49.27	31.30

Source: CRISIL Research. Mention what does the above figure denotes. Also add past performance disclaimer.

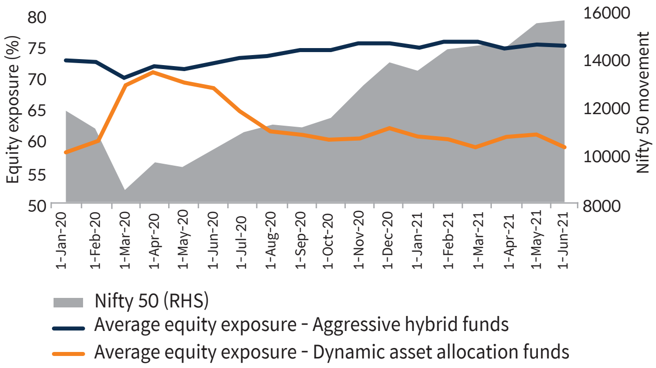
As shown in the numbers, stable asset allocation in the form of aggressive hybrid funds has generated superior returns in bull market phases as seen from the recent recovery of the equity markets post easing of the Covid-19 pandemic restrictions. Fund allocation with a higher equity exposure (aggressive funds) generated returns of nearly 50% since April 2020 till August 9, 2021 compared with that of dynamically managed equity funds of 31%.

The following chart shows that dynamic asset allocation funds varied their exposure to equity in the range of 55-71%. Such allocation, however, failed to capture the uptrend of the market during this period.

In the latest one year period, while equity markets have been on an uptrend, dynamic asset allocation funds have continued to reduce or keep their net equity exposure lower, thus limiting their gains.

On the other hand, while aggressive hybrid funds did not alter their allocation on a large scale, they moved in a small tactical range of 5-10% based on market movement to benefit from the opportunities available.

Net equity exposure versus Nifty 50 movement



Note: Equity allocation is shown net of derivative exposure
Source: CRISIL Research
Aggressive hybrid funds and Dynamic asset allocation funds as per SEBI Categorisation circular dated October 6, 2017.
Number of funds considered under Aggressive hybrid funds is ___ and Dynamic asset allocation funds is ___.
Past performance may or may not sustain in future.

Further even the timing of dynamic asset allocation funds has not mirrored market movement. While these funds went contrarian by investing higher in equity assets during the sharp bear phase of March 2020, they quickly offloaded and their equity exposure came down to nearly 55% after that.

Hence, they could not benefit during the subsequent sharp bull run compared with aggressive hybrid funds which maintained a stable equity exposure.

Point-to-point returns as of August 9, 2021

Category/ Benchmark	1 year	3 years	5 years	7years	10 years
Aggressive hybrid funds	41.41	12.27	12.00	12.11	13.04
Dynamic asset allocation/ balanced advantage funds	22.51	9.48	9.36	9.77	11.87
CRISIL Hybrid 35+65 - Aggressive Index	32.71	13.21	13.07	12.68	12.78
CRISIL Hybrid 85+15 - Conservative Index	10.10	10.53	9.22	10.00	9.69
CRISIL Hybrid 50+50 - Moderate Index	25.58	12.59	12.03	11.98	11.94

Source: CRISIL Research
Aggressive hybrid funds and Dynamic asset allocation funds as per SEBI Categorisation circular dated October 6, 2017.
Number of funds considered under Aggressive hybrid funds is ___ and Dynamic asset allocation funds is ___.
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Further, aggressive hybrid funds with their strategic and stable asset allocation strategy have beaten dynamic asset allocation funds across all investment horizons as per the point-to-point return analysis highlighted in the table above.

In the latest one year, having a static higher exposure to equity has benefitted aggressive hybrid funds with average returns of over 41% compared to over 22% for dynamic asset allocation funds.

Even over the long-term horizon of 7-10 years, aggressive hybrid debt funds have outperformed dynamic asset allocation funds.

Further, a long period analysis of past 10 years carried out on the rolling return performance shows that on an average aggressive hybrid funds have generated higher returns versus dynamic asset allocation / BAF (Define BAF at one place) funds across 1, 3, 5 and 7 years.

Average returns and risk adjusted return analysis

		1 year	3 years	5 years	7years
Returns	Aggressive hybrid funds	12.1%	11.9%	11.8%	11.9%
	Dynamic asset allocation / BAF	10.7%	10.9%	10.7%	10.9%

Source: CRISIL Research
Rolling return done with a monthly shift and based on equal weighted index created of aggressive hybrid and dynamic asset allocation / balanced advantage funds
Green cells denote best performer with the broad parameter of returns in that period
Period of analysis (July 1, 2011 – August 1, 2021)
Aggressive hybrid funds and Dynamic asset allocation funds as per SEBI Categorisation circular dated October 6, 2017.
Number of funds considered under Aggressive hybrid funds is ___ and Dynamic asset allocation funds is ___.
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Systematic approach to investing

Systematic investment plans (SIPs) have emerged as a disciplined approach towards investing in equity oriented mutual funds. Within the hybrid fund category, aggressive hybrid funds presents an attractive opportunity to benefit from this medium compared with dynamic asset allocation funds. An analysis of SIP investment of Rs 10,000 over the past five years in aggressive hybrid funds versus dynamic asset allocation funds shows that investment of Rs 6 lakh rupees over the period in the former would have grown to Rs 8.65 lakh at 14.6% XIRR versus Rs 7.88 lakh in the latter at 10.9% XIRR.

Category	SIP period	SIP Invested Amount (Rs)	Value of money invested	XIRR
Aggressive hybrid funds	5 years	6,00,000	8,65,328	14.6%
Dynamic asset allocation / Balanced Advantage Funds	5 years	6,00,000	7,88,354	10.9%

Source: CRISIL Research
SIP analysis done on equal weighted index created of aggressive hybrid and dynamic asset allocation / balanced advantage funds
Period of analysis (July 1, 2016 – August 1, 2021)
Aggressive hybrid funds and Dynamic asset allocation funds as per SEBI Categorisation circular dated October 6, 2017.
Number of funds considered under Aggressive hybrid funds is ___ and Dynamic asset allocation funds is ___.
Past performance may or may not sustain in future.

Summing up

As the analysis indicates, sticking to a strategic asset allocation pattern based on the investor's risk-return profile has been more fruitful than one involving dynamic asset allocation. The costs associated with churning in the form of operational and taxation can add to the overall reduction of returns of the portfolio. Further, the dynamic asset allocation fund apply strategies that tend to be divergent across the category, some might work on valuation strategies, some on momentum, while others could follow contrarian strategies. These various strategies might be beneficial in some market phases and not in other, making it difficult for an investor to zoom in on the strategy apt for him / her.

Aggressive hybrid funds aim to provide an optimum opportunity for long-term investors with a higher risk return profile to benefit from a stable asset allocation strategy.

Investors should, however, undertake prudent scheme selection based on due diligence before investing in one.