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Relative Importance of Asset Allocation

Introduction

The global melt down of 2008, when almost all asset classes fell to their rock bottom, was exceptional. Once in a century event that is too rare to be of any practical significance. Normally different asset classes display counter cyclical behavior to each other during different time periods.

Types of asset classes:

This behavior underscores the risk in ignoring a wide range of asset classes and focusing too narrowly on one asset class or the other in investing. In India many of us have often focused exclusively on investing in equity at the expense of other assets. As a result many have suffered prolonged periods of depreciation in value of their investments, when equity markets have been down, rendering them either illiquid to take advantage of rising opportunities in other asset classes or simply ill-placed to meet any emergency needs.

There are many asset classes, each of varying risks and opportunities. For example, the low risk assets like cash, certificates of deposits with banks and fixed interest securities are at the one end of the risk spectrum and various classes of equities (small, mid and large caps or those in each of the sectors), commodities, real estate, derivatives, currency and several others are at the other end of this spectrum. Each of them throws up opportunity at different time and it is difficult to time investment to take advantage of this (for example, who would have thought in 2007 that gold would reach such levels as today or for that matter equity markets would go bust in 2008). Besides each of them is risky with some riskier but more profitable than others.

Performance of various asset classes

Particulars	6 months	1 year	3 years	5 years	7 years
Crisil Short Term Bond Index	2.09	4.51	7.04	6.72	5.96
BSE Sensex	15.21	15.33	0.27	17.29	21.29
Gold INR Returns	12.78	15.84	27.01	22.62	19.55

Returns are as on November 30, 2010. Returns <=1year: Absolute, Returns > 1 year:-Compounded Annualised Growth Rate (CAGR). BSE SENSEX represents equities and CRISIL Short Term Bond Index represents Debt.
Source: ICRA MFI, Bloomberg.

Possible Solutions:

In this maze of assets, appropriate allocation of investments across different assets and asset classes can help one get the best returns at different levels of risk. But, as an individual investor one may not know which asset to have in one's investment portfolio or how to distribute one's money across various assets to avoid poor performance of any one of them imperil the entire investment.

A large part of prudent investing consists of finding an asset allocation that is appropriate to one's appetite for and ability to shoulder the risk. Yet one may not be aware of one's own proclivities in this respect. While many investors would qualify to own all the key assets - equities, debt, real estate, gold and cash - when it comes to knowing how much of each, it is a bit tricky. This is where an honest, conservative and experienced financial planner can play an important role in helping one determine how much each asset must contribute to one's investment plan.

Conclusion

Asset allocation is no doubt important. In fact, many studies have confirmed that asset allocation is more important than straight forward security selection. For example, Brinson and others have shown that about 91 per cent of portfolio returns can be attributed to the portfolio's asset allocation. That said, finding a right wealth manager to help one articulate one's investment objectives and then aid one allocate one's funds across different asset classes to get there, is equally important.