How to Strike a Balance Between Physical Assets and Financial Assets?

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We all know that the asset allocation of Indian households is skewed towards physical assets such as property and gold. Moreover, the allocation to financial assets is also tilted towards traditional products like bank FDs, Post Offices deposits, etc. Equities as an asset class is grossly under-owned by Indian households and one of the primary reasons for this is the perceived risk associated with equities.

While it is true that equities are more volatile from a short term perspective, over long term disproportionate allocation to traditional products could actually prove to be risky for investors as an investment in such products often give returns which is minimal after adjusting for inflation and taxes.

We highlight the importance of equity allocation using a simple illustration of how it can positively impact the investor's ability to achieve their long term financial goals. One of the focal reasons for investors to shy away from investing in equities is the high volatility associated with this asset class. While we have witnessed things gradually changing over the years, especially among the young generation, we still have a huge proportion of investors in India who have been either staying away completely or have very little exposure to equities. This is quite alarming because the long term consequences of under exposure to an asset class with high growth potential can be far more severe than one can probably imagine.

But most investors are ignorant about this fact as they tend to overestimate the short term and underestimate the long term. Thus by avoiding equities while planning for their long term financial goals, investors take a huge long term risk in their quest to protect themselves from short term volatility. However, what these investors probably do not realize is that there is a fundamental difference between short term volatility and risk.

In fact, this is such a common mistake among investors that even the renowned global investor Warren Buffet, in his 2015 annual letter to Berkshire shareholders, thought it was worth discussing the difference between volatility and risk, and how it can cost money to those who cannot differentiate between the two.

If you are still wondering what we are talking about, let us try and understand this through an illustration. Imagine an individual aged 40 years, having an annual household expense of Rs. 6 lakh and an annual investment towards the retirement of Rs. 3 Lakh. Let's assume that with an increase in income, he is going to increase his investment every year by 10% and continue to contribute towards building his retirement corpus till age 60 which is when he intends to retire. Further, let's assume that the annual rate of inflation during his life time would be 6%.

Now let's visualize two scenarios, scenario A where he invests his retirement contributions in safe investments (with no or little volatility) which hypothetically yield him a post-tax annualized return of 8% and scenario B where he invests in a combination of asset classes including equities which yield him a post-tax annualized return of 12%. Under scenario A, his total retirement corpus at the age of 60 would be Rs. 1.97 crore whereas under scenario B the final corpus would be Rs. 2.65 crore – that's a difference of almost Rs. 68 lakhs. Over the 20 year period, his total principal amount invested would be approximately Rs. 1.72 crore. Thus under scenario A, his gains would be Rs. 25 lakhs (1.97 – 1.72) whereas, under scenario B, his gains would be approximately Rs. 93 lakhs (2.65 – 1.72) which is almost double the gains under scenario A.

Illustration:

Assumptions	Scenario A	Scenario B
Current annual household expense	Rs. 6 Lakh	Rs. 6 Lakh
Current annual investment	Rs. 3 Lakh	Rs. 3 Lakh
Increase in annual contribution	10%	10%
Total principal amount invested over 20 years	Rs. 1.72 crore	Rs. 1.72 crore
Assumed rate of annual inflation	6%	6%
Current age	40 years	40 years
Plan to retire at the age of	60 years	60 years
Return of investment till retirement	8%	12%

Outcome	Scenario A	Scenario B
Retirement corpus at age 60	Rs. 1.97 crore	Rs. 2.65 crore

For illustration purposes only

This illustration makes it amply clear that not investing in an asset class with high growth potential asset class such as equities for your long term financial goals could turn out to be extremely risky in the long run. In fact, what should make the equity allocation decision easy is that over long time horizon such as 15 or 20 years, the average return from equities could be much higher than other investment avenues and the probability of equity investment earning a lower return than so called safe or less volatile asset classes is extremely low and depends on the market conditions.

While planning for long term financial goals such as retirement, one typically invests at periodic intervals such as monthly or quarterly, which actually could further help in mitigating the risk in achieving the desired long term results.

However, as the famous saying goes… "There's no such thing as a free lunch" and investing is no exception. The cost of reducing the long term risk is that you need to stomach higher short term volatility. But fortunately there are investment products and solutions that could help tame such short term volatility to a large extent. Investing in balanced funds which allocate 65-70% of their portfolio to equities or adopting a dynamic asset allocation approach based on factors such as valuations could reduce the short term volatility substantially without diluting the long term potential benefits of equity investing significantly.

While if we look at data and numbers, the savings shift from physical assets to financial assets look marginal. If an individual has an exposure of 70% in physical assets and 30% in financial assets, it is advisable to have a gradual rise in the financial assets considering the metrics explained in the article above.

The basic aim of investment in assets is wealth creation. Thus, based on historical facts financial assets should get the highest share in the portfolio as compared to physical assets considering lack of liquidity. After identifying one's goals, one should build portfolios bespoke to meet those specific goals and have a judicial mix of both physical and financial assets. One should define the risk profile for every portfolio based on the goal and the time given to meet the goal and accordingly invest. As real assets and gold aim to hedge against inflation, the wealth created by these assets comparatively falls behind the potential wealth created by the financial instruments.

Source: Internal, ACE Equity, BSE, Berkshire Hathway website

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