Asset Allocation: The key to successful investing

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Novice investors feel that difference between successful investing and failure is in picking the right investment. They start believing that it is only about making the right investments that determine success. Nothing could be farther than the truth.

In reality, historical data tells us that no matter who we are, we don't know what the future brings. The only way to deal with this uncertainty is having a good mix of investments i.e. asset allocation is a key determinant for portfolio performance in the long-run. Such a mix assumes that you don't know what the future is going to hold and thus allocates money to different assets.

In this article, let us find out about asset allocation, it's importance, how different asset classes move differently and how you can use asset allocation to win the long-term battle.

What is Asset allocation?

Asset allocation, in its basic form, involves dividing your investment rupees among different assets, such as stocks, bonds, and cash. How much should go into which asset class is a personal decision. However, this decision is based on several factors such as one's life stage, investment tenure and one's risk appetite.

The practice of spreading money among different types of investments as a means to reduce risk is known as diversification. And asset allocation practices diversification. You may have heard about 'Don't put all your eggs in one basket'. Asset allocation tells us 'How to put your eggs in different baskets'.

Why practice asset allocation?

Before venturing into asset allocation, it is important to under the why aspect. The general goal of asset allocation is to minimize volatility of returns. If one chooses to invest in a single asset class, there could be times when that asset class turns very volatile thereby impacting one's entire investment portfolio. For instance: During 2014, equities rallied and benchmark index Nifty by up by 33%. However, in 2015, the same index was down 3%. Similarly in 2016, Government Securities, also called GSec, generated 15% returns but in 2017 it delivered zero returns!

What is important here is to understand that asset allocation can't ensure a profit or eliminate the risk of a loss, but it proves to be a buffer by way of ensuring that that not all the investment reacts to a development in a same manner, at the same time. Thus, if your investment in one asset category is performing poorly, the downside here is likely to be negated by another asset category which is performing well. As a result the overall impact on one's portfolio is limited to a large extent.

How different assets behave

Every asset class has unique characteristics owing to which one has to careful while building a portfolio. The presence of fixed income tends to render stability to the portfolio and aims to generate regular income, while equities tend to provide the growth element by providing higher return. However, this asset class brings along volatility which may be unnerving in the short term. Gold on the other hand, which tend to be a small portion of one's portfolio, acts as a hedge against inflation. In effect, each asset class has a role to play in one's portfolio.

Also, different asset classes react to an economic development is different manner. Equities do well under vastly different conditions compared to fixed income/debt investments. Equity market tends to generally perform well in expansionary economies i.e. lower interest rates, more money supply and increasing demand. On the other hand, GSecs tend to generally perform well in contracting economies i.e. higher interest rates, falling money supply and decline in demand.

Ideal for long-term

When investors are told they have to invest for the long-term, some are confused as to why 'long-term'. This confusion is understandable. When we look back at history, we know how different asset classes/categories have performed each year. But, looking ahead is a much more difficult task. This is where asset allocation plays a defining role. By sticking to simple principles of asset allocation, we can practice long-term investing and create wealth.

Imagine you had Rs 1 lakh to invest at the end of 2004. Your time horizon was 10 years. So, you invested Rs 1 lakh for 10 years i.e. 2005 to 2014. Below is a live example of how your investment journey would be if you invested only in stocks, only in GSecs and a mix of stocks & GSecs (65%-35%). As you can see, the asset allocation

approach gives you returns which are in the middle and also a smoother investment journey than the other two approaches.

Year	Stocks * return %	GSec # return %	Value of Rs 1 lakh invested in stocks	Value of Rs 1 lakh invested in GSecs	Value of Rs 1 lakh invested in 65% stocks and 35% in GSecs
2005	39	4	139000	104000	126750
2006	42	5	197380	109200	166517
2007	57	6	309887	115752	241939
2008	-51	28	151844	148163	150556
2009	78	-9	270283	134828	222874
2010	19	3	321637	138873	257669
2011	-24	2	244444	141650	208466
2012	29	11	315333	157232	259997
2013	8	-1	340559	155659	275844
2014	33	14	**452944**	**177452**	**356522**

** Nifty 50 TRI # Gsec – 10 year Government Security*

If you want a hands-free experience in terms of asset allocation, choose dynamic asset allocation funds. Such funds offer benefits like active asset allocation, diversification between asset classes, periodic review and re-balancing, and debt taxation with indexsation advantage. With such funds that capture the optimum allocation of debt & equity based on the attractiveness of one asset class over the other, new investors can experience better risk adjusted returns.

Conclusion - *Asset allocation helps investors sleep peacefully at night. This is because the asset allocation approach smoothens one's investment journey and takes away the extreme swings in portfolio value.*