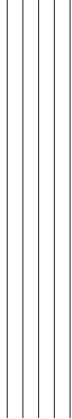


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Basics of asset allocation

For a cricket-frenzied nation, the role of the captain, bowler, wicket keeper and all rounder is pretty much well understood. After all, a winning team has the right set of players who perform their jobs most effectively in a manner that their team wins. Now, replace the team with your finances and the team players with different assets and you will have your investment portfolio.



For a portfolio to do well, you need a mix of assets that collectively work in a favourable manner. In its simplest form, asset allocation is how your investments are distributed among the different asset classes such as fixed income, equities, real estate, gold and even cash. It is for this reason that asset allocation is an important factor in determining that a portfolio performs in line with an investor's goals and may help you achieve better returns while lowering risk.

No wonder financial planners' stress that an asset allocation establishes the framework of an investor's portfolio. Various researches over the years conclude that proper asset allocation has the potential to increase investment results and lower overall portfolio volatility. To arrive at the ideal asset allocation that is tailored to suit individuals, the investment risk associated with the asset class has to be ascertained and matched to an investor's comfort with risk.



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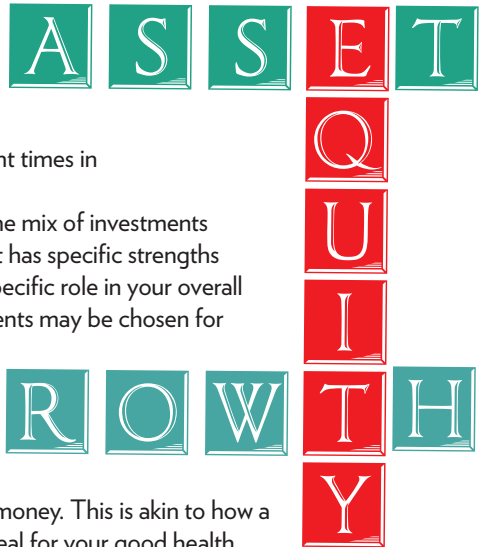
Finding the right mix

A dosa, idli or vada are all very different, but they are generally made of the same batter. The preparation varies – one is roasted, the other steamed and the last is deep fried. Depending on your age and health condition, you can consume all without fear or be strictly told to look at only the steamed idli and no more.

The same is true of your investments. If you are the kind who can take risks, your investment basket will have a healthy dose of equities, which is the only asset class that has the potential to beat inflation in the long run. However, if you are a risk-averse investor, it is more likely that you will have your money spread into fixed return instruments like bank fixed deposits and other government schemes.

The mix of various asset classes, such as stocks, bonds, gold, real estate and cash alternatives, accounts for most of the ups and downs of a portfolio's returns. The role of each of these assets will vary in your portfolio at different times in your life.

There's another reason to think about the mix of investments in your portfolio. Each type of investment has specific strengths and weaknesses that enable it to play a specific role in your overall investments. For example, some investments may be chosen for their growth potential, and at the same time, some others may be chosen for regular income. Still others may offer safety or simply serve as a temporary place to park your money. This is akin to how a dietician recommends a well-balanced meal for your good health.



Different assets, different risks

There are a number of different asset classes that you can invest in and each of them comes with their own risks. Before you proceed further, it will be prudent if you understand the risks that each one of them brings with it.



Cash: Yes, cash is the least risky of the lot, but it does not add any value to your money's worth when left idle. In fact, cash in the wallet for a year, only goes down in value, in times of high inflation.



Bonds: A step higher than cash on the risk ladder, fixed deposits or government backed securities or corporate bonds, pay out a fixed return. The risks associated with these are low, but they are not completely without risks. For instance, a bond could default to pay out the interest to you in time and could possibly default on the principal too.



Equities: Shares in companies or units in equity mutual funds are seen as the most risky asset class, as stock markets can be highly unpredictable. Even within this asset class, there could be certain sectors that are riskier and certain kind of stocks (small-cap) which rests at a very high risk grade.



Real estate: Investing in property, such as house or commercial spaces can grow your money through rental income and growth in the value of the property you own. However, the risk is more on liquidity – you may not find a buyer when you wish to exit or there may be times when you do not find a tenant.

! *Asset allocation involves dividing an investment portfolio among different asset categories such as stocks, bonds and cash.*



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Risk profile and returns



Risk and Reward are two sides of the same coin. The old adage hold good: the higher the risk, the higher the potential return and conversely the lower risk tends to possess lower potential for a return. But in either case, it's important to understand your personal risk quotient – your ability to take risk when investing, basically, how much can you afford to lose?

It is natural for everyone to want the biggest and best returns on their investment. However, higher returns tend to involve investing in higher risk options. And that generally comes with higher levels of volatility. Thus, being comfortable with your investment strategy is just as important as achieving your investment goals. It's about understanding your risk tolerance, and getting the right balance between risk and return.

Two questions you need to ask yourself are – **how long do you have to invest and how comfortable you are with the investment risk?** The longer you have to invest, the more likely it is that you will be able to ride out any ups and downs in the market.

As for your comfort to risk, the simplest way to answer is to ask yourself, if your investment dropped in value, even temporarily, would you worry or lose sleep over it? If your answer is yes, then you're probably not suited to a high risk option.

	DURATION	SUITABILITY
Short term	Less than 3 years	Higher risk options may not suit you
Medium term	3 to 7 years	A conservative or balanced option might suit you best
Long term	Above 7 years	You probably have time to ride out the ups and downs of a higher risk option

Maintaining asset allocation

By now you must have understood that you should make a conscious decision about how to allocate your assets. This however, is not a onetime process and should be rebalanced periodically. Maintaining an appropriate asset allocation is critical to aligning your investment strategy with your overall investment objectives. Of course, asset allocation does not ensure a profit or protect against a loss, but by maintaining the asset allocation, you reduce the probability of loss to your investment.



Asset allocation is not a onetime process; it is a dynamic process which should be maintained periodically, because market movements can dramatically alter your asset allocation over time.

Most importantly, rebalancing keeps your portfolio consistent with your risk profile. For instance, a retiree who relies on his portfolio for income shouldn't be invested in 90 per cent stocks, just the way a 25-year-old who won't retire for at least 30 years shouldn't be invested in 90 per cent bonds. What's important is that you periodically check your portfolio to see if rebalancing is necessary.

While there is certainly no guarantee that this phenomenon will occur, properly executed rebalancing plans within well-diversified portfolios have been shown to increase annual returns by small amounts. To illustrate the point, we explored an asset allocation with equal allocation to equity and debt.

Rebalancing establishes good investing habits. It may seem counterintuitive to sell an asset that's performing well, but that's exactly what you should do. Rebalancing forces you to buy low and sell high. If this is unclear, see the example.

- ! *Setting goals helps you to match your time horizon to your asset allocation,*
- *which means you take on the optimum amount of risk.*

Allocation at work

Assuming you start with equal allocation to equities and bonds and equities gain 50 per cent at the end of the year, with no gain in bonds.

	JAN 1, YEAR 1	DEC 31, YEAR 1
Stocks	₹10,000 (50%)	₹15,000 (60%)
Bonds	₹10,000 (50%)	₹10,000 (40%)
Total	₹20,000	₹25,000

A year later without rebalancing

	JAN 1, YEAR 2	DEC 31, YEAR 2
Stocks	₹15,000 (60%)	₹10,500 (51%)
Bonds	₹10,000 (40%)	₹10,000 (49%)
Total	₹25,000	₹20,500

Assuming you do not rebalance your portfolio at the end of year 1 and that year 2 is bad for equities, which goes down by 30 per cent and there is no change in bond returns, the 2-year annualised portfolio works to 1.24 per cent

A year later with rebalancing

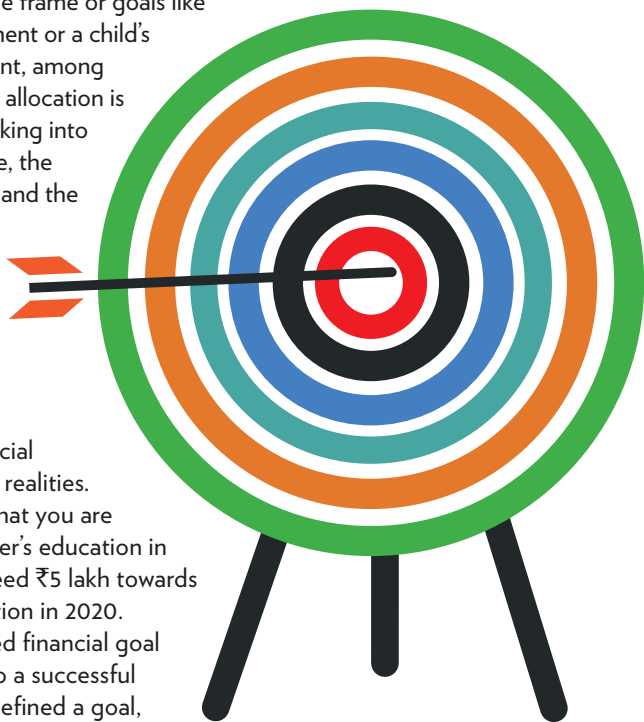
	JAN 1, YEAR 2	DEC 31, YEAR 2
Stocks	₹12,500 (50%)	₹8,750 (41%)
Bonds	₹12,500 (50%)	₹12,500 (59%)
Total	₹25,000	₹21,250

Assuming you are disciplined with investments and follow the original asset allocation with annual rebalancing, you will sell ₹2,500 worth of equities and invest the same in bonds to bring them to the original balanced levels. In this case, even though year 2 is bad for equities, which goes down by 30 per cent, and there is no change in bond returns, the 2-year annualised portfolio returns works to 3.08 per cent.

Goal-based asset allocation

Each one of us have financial goals like long-term, short-term and medium-term depending on time frame or goals like saving for a down payment or a child's education and retirement, among others. The goal-based allocation is an exercise designed taking into account your risk profile, the varying goals you have and the time that is needed for them to occur.

The starting point for a goal-based framework is to help you translate goals and objectives expressed in non-financial language into financial realities. So, instead of stating that you are saving for your daughter's education in 2020, state that you need ₹5 lakh towards your daughter's education in 2020. Having a clearly defined financial goal is the stepping stone to a successful plan. Once you have defined a goal, the next step is asset and division to achieve your goal.



Planning in buckets

Traditionally, investors have used asset allocation to meet investment goals by combining different assets into a single portfolio that is then optimised to provide the highest possible return for a given level of risk. In this instance, success is generally measured by how well that portfolio performs relative to a market benchmark. This approach has proven to be very effective in helping to maximise the risk-return relationship of a portfolio.

As you typically have more than one financial goal to achieve, it makes immense sense to have different investment buckets. This way, you can reduce the chances of disconnect between risk tolerance, potential investment return and investment goals. Bucketing also helps address key psychological roadblocks. By creating regular investments into different buckets that are linked to your financial goals, you know the progress made by your investments towards each of your financial goals. This way, you can make changes to your investments depending on your changing risk profile and also to make the investments achieve your financial goal.

The key advantage of the bucket approach is that you closely align risk management with your financial goals



Place where you put money into investments that are fairly secure, like cash and near cash. These don't give you huge returns, but ensure safety and liquidity.



Where you would put growth investments. Down payment for a house, a vacation three years later and so on.



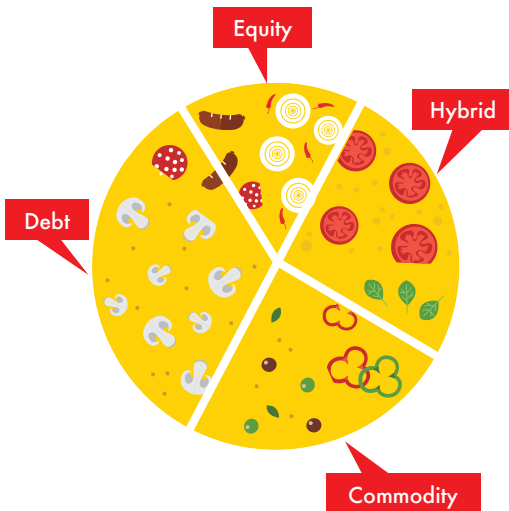
The things that you want several years later in life such as retirement and may be a dream second home.

- ! Younger investors may want to allocate their long-term retirement assets to riskier investments, such as equities, because they have time on their side.

Diversification and

The best way to understand diversification is to refer to the maxim “don’t put all of your eggs in one basket.” Diversification is the practice of spreading your investments around so that your exposure to any one type of asset is limited. If asset allocation is the first step to investing, which helps you divide your investments into different asset types, diversification is the second most important step in helping you choose different options within asset classes.

By investing in instruments that do not move up and down together, the overall risk of a total diversified portfolio is lower than the risk of each individual investment within the portfolio. For instance, even within equities as an asset class, different sectors fare differently at different times. Likewise, segments of the markets, like the mid-cap segment fares better than a large-cap segment during a bull market rally. Simply put, diversification means spreading the risk over different asset classes and over different time periods. The aim of diversification is to decrease the total risk in a portfolio by spreading the money over many smaller investments. This practice is designed to help reduce the volatility of your portfolio over time.



nd Mutual Funds

When investing in equities as an asset class, the role played by mutual funds is extremely important. Unlike stocks, equity MFs offer diversification that stock investment does not. Another way to understand this is the risk that a single stock has, compared to a fund which comprises of a portfolio, thereby spreading the risk.

- ✔ It can be quite costly and complicated for an ordinary investor to construct and maintain a truly diversified portfolio of stocks. Instead, you may find it easier to diversify through investing in mutual funds.
- ✔ A mutual fund is a professionally managed type of collective investment scheme that pools money from many investors for investing in equities, bonds, money market instruments, and other financial instruments.
- ✔ With the broad range of mutual funds being offered in the marketplace which are invested across different asset classes and different companies, you can enjoy the benefits of instant diversification.
- ✔ Mutual funds also follow a disciplined asset rebalance procedure which aids in its overall performance and risk management.
- ✔ You can opt for an investment portfolio that best suits your changing needs, given the wide variety of choice even within different asset classes as there are diversified equity funds, sector funds, debt funds of different categories, index funds and even funds that invest in commodities.
- ✔ Mutual funds offer economy of scale. The money you invest buys a pool of assets, which is cheaper and more convenient than buying each security individually.
- ✔ Besides, mutual funds can offer you liquidity as you can buy and sell your funds and avoid doing all the administrative and research work by letting professional fund managers to work for you.

Investor profile and asset allocation

Asset allocation is the DNA of your investment portfolio and varies depending on your profile and the investment time frame.



Aggressive growth

This type of investor is willing and able to take substantial risk to achieve their goals. They seek high growth potential and primarily use equities to achieve their goals, and holdings in bonds may be very low.



Moderate growth

This type of investor is willing and able to take some risk. They seek to achieve growth but are averse to taking on large amounts of risk. By balancing allocations with a slight tilt toward stocks, such investors place growth as a primary emphasis and current income as a secondary emphasis.



Conservative

This type of investor is willing and able to take a small amount of risk to achieve investment goals. While growth is important to them, controlling risk is a priority. With a large allocation to bonds, and small allocation to stocks, they attempt to achieve moderate year-to-year performance fluctuations for capital appreciation.



Risk averse

This type of investor highlights risk as a main concern and seek a current stream of income and are not as concerned about the growth of the portfolio and invest in a portfolio that mainly comprises of bonds, with negligible allocation to equities.

! *Strong long-term asset allocation across a range of asset classes can help investors maximise returns and achieve their goals in retirement.*



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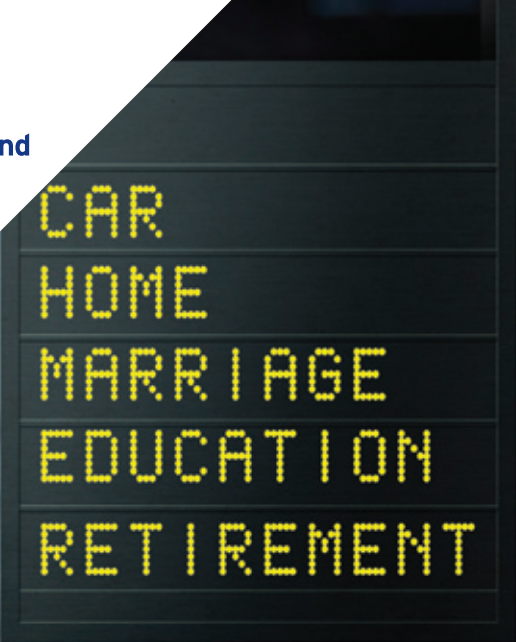
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Simple asset allocation rules

- The higher return you want, the more risk you'll usually have to accept
- The more risk you take with your investments, the greater the chance of losing some or all of your initial investment (your capital)
- If you're saving over the short-term, it's wise not to take much capital risk. So what you are investing for and when you'll need access to your money will have a big impact on what types of investments are right for you
- If you are investing for the long-term, you can afford to take more risk as your money has more time to recover from falls in the markets
- Investing in share-based assets has historically proved to be the best way for providing growth that outstrips inflation. There is a risk attached but, when you invest over the long-term, there is more time to recover your losses after a fall in the stock market





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