ET IN THE CLASSROOM

Importance of Asset Allocation

The recent sharp volatility in the stock markets has retail investors worried, especially those who put all their money into equity and ignored fixed income and gold. Financial planners insist that investors should build their portfolios using an asset allocation approach giving importance to all assets. Fund houses offer a number of schemes across equity, fixed income and gold, making it easy to build a portfolio using this method.

WHAT IS ASSET ALLOCATION? WHY IS IT IMPORTANT?

Asset allocation is deciding the allocation to equity, fixed income, gold, international equity, REITs and cash – the most common components of an asset allocation strategy. This helps smoothen investment journeys by minimising volatility and maximising returns. This also helps divide money among assets that do not all respond to the same market forces in the same way at the same time. The allocation to each asset class will vary between investors and will be determined based on age, lifestyle, goals and risk appetite. A conservative investor will be told to hold 40% in equity mutual funds, 40% in debt mutual funds/REITs, 10% in international equity and 10% in gold/silver funds.

HOW DO MUTUAL FUNDS HELP DIVERSIFY ACROSS ASSETS?

There are several ways to allocate across asset classes using mutual funds. For a moderate-risk investor, the simplest way is to put 50-60% into equity-oriented funds, 30% in debt-oriented schemes and 10% in gold /silver funds. Within equities, half could go into a passive large-cap index fund and the balance to a mix of mid-cap, small-cap and thematic funds. In debt, it could go into a mix of ultra-short and duration funds, while the balance could go to a gold ETF or gold saving funds. Besides, asset allocation can be done using a combination of mutual fund schemes. Investors looking at one mutual fund scheme for diversification could buy a multi-asset fund. Investors looking to have 65-70% equity and 30-35% debt could opt for an aggressive hybrid fund, while those looking for 15-25% equity with the rest in fixed income can go for an equity savings fund.

IS IT NECESSARY TO FOLLOW AN ASSET ALLOCATION APPROACH?

It is difficult for any individual to predict when equities will rise or when they could correct. So when equities go down, and you have all your money in that asset class, you will be hit hard. However, if you have allocated to gold and debt, your portfolio can be protected. Hence spreading wealth across assets gives the best risk-adjusted returns. Wealth managers believe in the long term, 90% of the returns come from proper asset allocation.

HOW OFTEN SHOULD YOU REVIEW YOUR PORTFOLIO?

Investors should review it at least once a quarter or in six months. If any asset moves up or down by more than 10% of the planned targeted allocation, investors could take steps to rebalance their portfolios.

PRASHANT MAHESH