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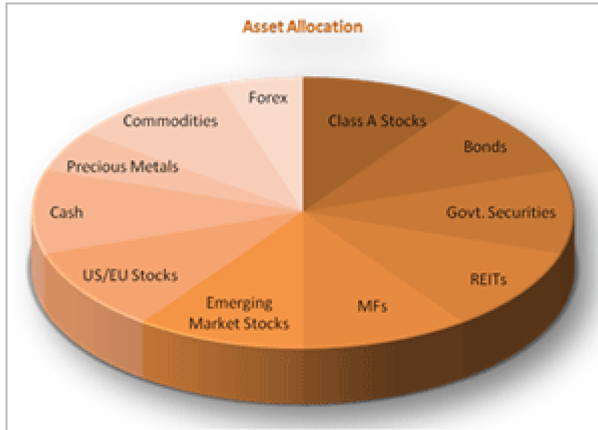

No doubt you’ve heard there’s no reward without risk. That’s as true of investing as it is of anything in life. Successful investing begins by conceding that – to a degree – uncertainty will always be your partner. You can guess what the market is going to do and you can either be right or wrong. Or you let some self-styled "expert" do the guessing for you. But no one guesses right consistently.

Back in the 1700s, a cry rose up – "Don’t put all your eggs in one basket!" That was for a severe shortage of eggs after a series of unfortunate events. It made a lot of sense, but raised a question – "Which sets of eggs in which baskets?" Almost four centuries later this is advice is still good: "Don’t put all your eggs in one basket!" Here, these eggs are our own funds. Hence, that would translate to "Don’t invest all your funds in one place!"

Most individual investors are usually obsessed with finding the "superstar" stock pick. They completely ignore the balancing needed to generate long term "wealth". Anyone can pick a winning horse once in a while and make some money. But can you do that every day? Probably not, and that’s most people lose money at gambling.

"Oh that means, *diversify*! I already do that." Well, diversify doesn’t mean 3 different tech stocks. That’s not what Asset Allocation is all about.

Imagine being at a street vendor. He sells sun glasses and umbrellas and some other items that are completely unrelated to each other. But he knows, on a summer day sun glasses will sell and on a rainy day umbrellas will sell. Basically, he doesn’t want to go home without earning something on any single day. Thus, he invested his limited money in buying completely different items that will sell in different conditions. That’s Asset Allocation.

Technically, Asset Allocation refers toinvesting resources/funds across a broad spectrum of asset classes like Equity, Bonds,Commodities, Cash, etc but not just across different securities but also across differentmarkets.

Different asset classes are imperfectly correlated – which means some go zig and some go zag. However, it will ensure that your overall portfolio is less volatile. In simple words, you can sleep better.

However, it is seen that when you talk about asset allocation, for some reason, most investors will gaze at you like you've asked them to understand rocket science.

At its core, this process is as simple as knowing yourself combined with some discipline. All you need to do is consider two factors honestly. Stress and Greed.

Your own risk taking capability is a key factor here. Another key factor is the time horizon.

Everyone would like to turn a 100 Rupee grubstake into a few crores. If you're too greedy or too hungry, you are likely to take too much risk chasing the return and ultimately end up with nothing; or worse, end up with some debt on a margined trading account. Remember, security trading firms will most likely lure you into this. Hence, it is extremely important, is to be realistic about your return expectations.

Asset allocation should form the foundation stone of your investment plan. It is critical to building your long term financial health and security. If your asset allocation strategy is right, you will survive The Great Depression. In this respect, Asset allocation or appropriate diversification is "the only free lunch you will find in the investment game." The biggest job you have as an investor is to manage your risk.

The big question – Where do I start?
First thing you should do at the drawing board, is understand yourself better. It is most important, that you NEVER ignore your emotions or your "better judgement" in order to chase higher returns. It's just not worth it. It is never acceptable or advisable to manage a portfolio in violation of your risk tolerance. Year after year, we have seen people who have learnt it the hard way, making it an extremely expensive lesson.

Second thing, that you should do, is to study some historic data. Your relationship manager will give you this. The past is usually a more reliable indicator of risk that it is of returns. For any given combination of assets, the pattern of volatility is likely to be more predictable than the pattern of return.

You may be able to increase your risk tolerance with education. But for most of us, risk tolerance or aversion is a part of who we are and is not subject to much change. So unless you are sure of being comfortable with higher risk, do not chase higher return at the expense of your sleep. Finding the right ratio of risks and rewards is one of the most important things an investor can do – perhaps more important than anything else.

Now, having understood some basic fundamental philosophy of appropriate investing, a question still remains. Just how far should you go in one direction or the other? Your goal is not to find the very best asset allocation; no one knows what that will be. Instead, you have to choose an allocation that has performed well in different scenarios and won't give you a heart attack.

Getting your allocation right, will have a significant impact on your long term returns – more than anything else. It is more important than the individual investments you choose.

How to strike the right asset allocation mix?
As an investor, you are risks in many forms. The risk of a downturn in stock prices. The risk, that inflation will erode asset's buying power. The risk of political instability affecting international markets. The risk of foreign exchange fluctuations for your international investments. So on and so forth. Hence, to achieve a long term financial goal, you must accept a trade-off between risks and rewards. You must also understand some basic historical patterns that have gone along with three primary asset classes – Stocks (Equity), Bonds (Debt) and Cash.

Fundamentally, how you should allocate your assets across these three classes, will depend on how much risk you are willing to take for an expected return. That will depend on why you're are investing and when you need your money.

Now ask yourself these three questions:

What are your goals and your time frame?,

Are you saving for your retirement or a vacation or whatever the reason may be?

Next, set a reasonable time period to reach your goals.

Generally, the longer your time frame, you have the liberty to invest more money in stocks, which have had the greatest long term growth potential. For shorter term goals – less than one year – you can think about conservative cash investments such as money market funds. For example, you are saving for a down payment for your new house 3 years later, you can give more allocation to lower risk assets like short term bonds. Or if you are looking at retirement as a goal, you may be able to aggressively invest in stocks, as long as you are willing to accept the risk.

How well do you sleep at night?
Over the last few decades (almost 8), we have seen that stocks have turned in the strongest overall performance across these three asset classes, however with some very painful short-term setbacks along the way. Hence, you need to expect the unexpected and be prepared for both, good and bad days in office.

The annual returns for stocks have fluctuated much more dramatically compared to bonds and cash. It's easy to handle the upside of stocks, but a lot of people have trouble sleeping after a steep drop. While bonds haven't offered the same high return potential as stocks, they haven't fallen as much either. That's why having a mix of all three asset classes can sometimes lessen the severity of nightmares.

Are all your eggs in one basket?
You can reduce your investment risk further by diversification – across all asset classes, market sectors, capitalization levels, countries, type of economies, etc. An easier way to do this is by investing in Mutual Funds – access to multiple asset classes through one vehicle.

However, just bear in mind, that no amount of diversification and no asset allocation strategy can guarantee profit or security against losses in a declining market.

Stay Focused and Balanced
Once you have implemented an asset allocation strategy, keep in mind, that day-to-day changes in the markets can also affect your portfolio without you noticing it and also without you making any further transactions.

Realistically, you'd be taking more risk than you'd intended. Hence, it's only wise enough to periodically rebalance your asset mix keeping from getting too far from your allocation target.

Final Notes

1. All investments are subject to risks.
2. Foreign investments involve additional risks like foreign currency fluctuations, political instability, etc.
3. Investments in bonds involve risks of interest rates, credit and inflation.

4. Prices of Mid-cap and Small-cap fluctuate more than Large-caps.
5. Past performance is no guarantee of future performance. Instead it is a reliable indicator of risk.
6. For broadly diversified portfolios, the asset mix has greater influence than individual investments.
7. **As a general rule of thumb :**

- If you need the money next year, invest in cash.
- If you need the money in the 1-5 years, invest in safe income producing instruments like bonds, etc.
- Any money that you don't need in the next 5 years is a candidate for the stock markets.

Some useful Asset Allocation models :

- Conservative (low stress, low greed): 40% equities, 35% bonds, 25% cash
- Moderate (average stress, average greed): 60% equities, 25% bonds, 15% cash
- Aggressive (high stress, high greed): 80% equities, 15% bonds, 5% cash

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