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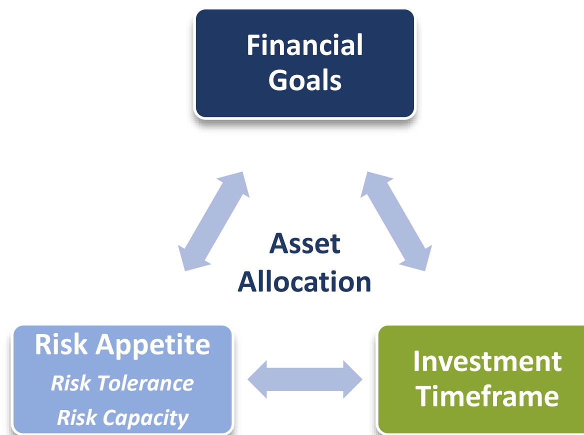
# CONCEPTOPEDIA

## “Asset Allocation – Explained”

# What is meant by Asset Allocation?

- It is the process of dividing one's portfolio among various asset classes like equity, fixed income, cash, alternatives etc.
- It is devised basis an investor's goal or financial objectives, investment tenure and risk appetite.

**Simply put, asset allocation is an investment strategy that is aimed at balancing risk and reward.**




# Reasons for Asset Allocation

**Each asset class has its advantages and disadvantages.**

*For instance, while equity has the propensity to create wealth in the long run, how-ever it is volatile in the short run. Fixed Income on the other hand is far less volatile and a traditional fixed income security provides the benefit of periodic cashflow (interest income) and return of principal amount at maturity. How-ever it is susceptible to interest rate risk (listed debt instruments), credit risk, liquidity risk etc. and may not generate a healthy real rate of return (return over inflation rate).*

**The asset returns may not be positively correlated to each other. Hence lower the correlation of asset returns, the greater the risk reduction and diversification benefit of combining assets in a portfolio. (Please refer 1b)**

**Winners rotate - No asset class continues to perennially occupy the numero uno position in term of performance. (Please refer 1a)**

**Each asset class has its unique risk (standard deviation) - return characteristics.**

1a

**The asset allocation quilt**

The table ranks 10 asset classes in order of their return performance—from the highest to lowest—for each calendar year in the 10-year period from 2013 to 2022. The absence of any pattern in the returns of asset classes from one year to the next reinforces the importance of asset allocation to build a balanced portfolio against trying to consistently predict the next winning asset class. A diversified portfolio of stocks, bonds, and physical assets is key to steering through every market condition. Such a portfolio may not deliver the highest return in any given year but will perform competitively across market cycles.

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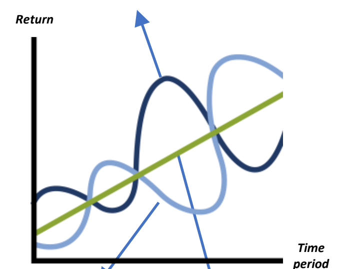
| 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|---|---|
| International 45.7 | Small-cap 62.9 | Credit risk 10.00 | G-sec 15.0 | Small-cap 59.6 | Gold 8.4 | International 31.8 | Small-cap 30.8 | Small-cap 62.8 | Gold 11.3 |
| Large-cap 9.0 | Mid-cap 54.7 | Corporate bond 9.00 | International 12.5 | Mid-cap 48.1 | G-sec 8.0 | Gold 21.1 | Gold 27.6 | Mid-cap 39.2 | Credit risk 5.2 |
| Real estate 7.5 | Large-cap 29.9 | Mid-cap 7.4 | Corporate bond 12.0 | Large-cap 27.9 | Large-cap 5.9 | Large-cap 12.6 | International 19.0 | International 29.1 | Large-cap 2.7 |
| Credit risk 7.0 | G-sec 17.0 | G-sec 7.0 | Credit risk 12.0 | International 12.3 | Corporate bond 5.0 | G-sec 12.0 | Mid-cap 18.8 | Large-cap 22.0 | Corporate bond 2.7 |
| Corporate bond 6.00 | Credit risk 14.0 | Small-cap 6.1 | Gold 10.9 | Credit risk 8.0 | Credit risk 5.0 | Corporate bond 10.0 | Large-cap 14.6 | Credit risk 8.6 | T-Bill 2.5 |
| T-Bill 5.5 | International 13.6 | T-Bill 5.4 | Real estate 9.6 | Corporate bond 7.0 | Real estate 4.8 | Credit risk 8.0 | G-sec 12.8 | Corporate bond 4.9 | G-sec 2.3 |
| G-sec 2.0 | Corporate bond 13.0 | Real estate 4.5 | Mid-cap 8.0 | Real estate 6.4 | T-Bill 4.1 | T-Bill 4.2 | Corporate bond 12.3 | Real estate 3.1 | Real estate 1.4 |
| Mid-cap -5.7 | Real estate 11.9 | International 4.2 | T-Bill 4.7 | Gold 6.0 | International 2.4 | Real estate 4.2 | Credit risk 11.4 | G-sec 2.2 | Mid-cap -2.2 |
| Small-cap -9.7 | T-Bill 5.7 | Large-cap -5.0 | Large-cap 1.9 | T-Bill 4.0 | Mid-cap -13.4 | Mid-cap -4.0 | T-Bill 3.1 | T-Bill 2.0 | Small-cap -7.5 |
| Gold -18.0 | Gold 2.2 | Gold -7.9 | Small-cap 1.8 | G-sec 2.0 | Small-cap -23.5 | Small-cap -9.0 | Real estate 1.2 | Gold -2.7 | International -10.0 |

Returns as of 23 December, 2022. T-Bill: treasury bills; G-secs: government securities. For large-cap, we have used S&P BSE Sensex data. For mid-cap, S&P BSE Midcap data. For small-cap, S&P BSE Smallcap data. For T-Bills, CCIL T-Bill Liquidity Weight data. For G-secs, CCIL All Sovereign Bond Index data. For corporate bonds, Crisil Corporate Bond Composite Index data. For credit risk, Crisil Composite Credit Risk data. For international, S&P 500 data (converted to rupee returns). For gold, prices as per World Gold Council. For real estate, RBI House Price Index is available only upto Q2 of FY 2022-23 (showing 9-month return)

Source: Mint research

1b

Hypothetical Price Movement of Asset Class 1




Hypothetical Price Movement of Asset Class 2

Hypothetical Price Movement of a Portfolio comprising Asset Class 1+ 2

*Image Source: https://www.livemint.com/money/personal-finance/an-year-of-dim-investment-returns-11672247151041.html*

Disclaimer:- The chart and picture is for illustrative and educational purposes only and strictly for internal use. Past performance may not sustain in future.

## What is meant by Rebalancing?

- Rebalancing means **reinstating an investment portfolio back to its original asset allocation.**

- If, over time our portfolio moves away from its original asset allocation, we may expose ourself to one of two scenarios:

✓ Our exposure to risk could increase beyond our comfort level.
✓ Any turbulent market conditions may negatively impact the portfolio returns.

- By rebalancing the portfolio on a regular basis, we ensure that the portfolio remains in line to the original asset allocation plan, where-as at the same time the risk gets minimized, with the returns being reasonable.

| Example | Equity | Fixed Income |
|---|---|---|
| Target Allocation | 70% | 30% |
| **Market Fluctuation** | **80%** | **20%** |
| **Rebalance** | **70%** | **30%** |

For example, assume the strategic asset allocation weight for an investor is 70% into Equities and 30% into Fixed Income, how-ever due to market swings the portfolio weights has undergone a change.

By implementing a rebalancing strategy, one can either redeem the appreciated portion of equity and deploy the same into fixed income or invest an additional amount into fixed income to reinstate the portfolio back to its original asset allocation.

However, one should also consider the impact of taxes, transaction costs, and exit loads etc. while rebalancing.

*Key benefit of rebalancing is that it helps to **buy low, and sell high**, in an objective manner without heeding too much to impulse, intuition and hearsay.*

# Difference between Strategic, Tactical & Dynamic Asset Allocation Strategies

| Strategic Asset Allocation | Tactical Asset Allocation | Dynamic Asset Allocation |
|---|---|---|
| It is a set of percentage allocation to various asset classes that is designed to meet the investor's objectives. | It is an asset allocation that deviates from the baseline (strategic) asset allocation in order to profit from the forecast of short-term opportunities in specific asset class. | It is an asset allocation strategy that uses mathematical models comprising various valuation indicators like PB ratio, Yield Ratio, VIX etc. to ascertain the attractiveness of markets and to decide the asset allocation mix in various class. |
| Asset Class weights are rebalanced as per fixed rules. | Portfolio weights are tilted towards the most attractive asset class. | It involves frequent adjusting of asset weights based on market conditions, proprietary model indicators and fund manager's judgement and discretion. |

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