The Economic Times

INVESTING | ETPrime

Decoding investment advice

By Devina Mehra Aug 22, 2023, 04:15 AM IST

Synopsis

It appears that investors do not clearly understand that for instance equity and gold are two different asset types altogether, whereas mutual funds and ETFs, or even buying stocks directly in the market, are merely structures to invest in those assets.

I was scheduled to write an article here, had the topic and my notes ready; and then came a small virtual meet with a few professionals last week, which upended my thought process.

These were people who were successful in their own fields: there were doctors, SME manufacturers, hoteliers etc. However, this was not a group which was looking at investments or financial markets on a daily basis – they were instead relying on financial advisors, formal or informal, to guide them.

The questions they asked surprised and somewhat alarmed me. Let me share some samples:

- I have been doing a systematic investment plan (SIP) in an equity mutual fund, but my advisor tells me that mutual funds are yesterday's story, and he is advising me to invest in a global Gold ETF (Exchange Traded Fund). What do you think?
- Should I invest in a mutual fund or an AIF (Alternative Investment Fund)?
- A large chunk of my investments is via an insurance policy; do you think it's ok?
- Should I put a lump sum in a fixed-income mutual fund or do an SIP in an equity portfolio management service (PMS)?

These queries came out of recommendations from their financial advisors, bank relationship managers, wealth managers, neighbourhood insurance agents, and so on.

The ‘mis-selling’ in financial services has always concerned me, where there is often a disregard for the investors’ welfare and the agent or intermediary is basically trying to maximise their own commission.

This is called the classic agency problem in economics, where the welfare of the agent and the person they are advising or managing money for is not aligned. Basically, the agent will make more money if the investor invests in something that may not be optimal for the latter.

In any financial transaction, you must ask, ‘Cui bono’ which is the Latin term for who gains?

Therefore, always ask anyone advising you what they are going to make out of the transaction: what is their commission or fees – although even then you may or may not get the truth on this.

Two, learn the basics of how to calculate the Internal Rate of Return (IRR) of any investment, considering all that you pay for and all that you receive. This is essential to calculate your actual return on everything from insurance policies to real estate.

But even leaving both these things aside for another time, in all the questions that were mentioned above, there is a basic mix-up between assets or asset classes and the structure of the investment.

It appears that investors do not clearly understand that, for instance, equity and gold are two different asset types altogether, whereas mutual funds and ETFs, or even buying stocks directly in the market, are merely structures to invest in those assets.

Therefore, you must first decide on which asset you want to invest in and only then can you decide which is the optimal *structure or way* to invest in those assets.

An equity mutual fund is not directly comparable with a Gold ETF for instance, because, in this example, you are changing both the asset class as well as the structure for investment.

Let us first understand what an asset class is.

The definition that you will see in finance textbooks or investment dictionaries is along the lines of “An asset class is a group of financial instruments that have similar financial characteristics and behave similarly in the marketplace.”

These can be both financial assets (like shares or bonds) or real assets (like a house or apartment).

In case that sounds too generic or confusing here are the general categories of asset classes:

- Equities
- Fixed income or debt
- Commodities (can be further categorised into gold and precious metals; oil, gas and energy, industrial metals, agricultural products etc.). In India, the only commodity you can easily invest in is gold (or silver)
- Real estate
- Cash and near cash
- Foreign currencies
- Alternative assets that can span a range from art to cryptos. Some definitions will also include unlisted equity, say in venture capital or angel funding, in this category.

While these are the broad classifications, there is another definition dimension to look at assets which is the geographical dimension. That is, you can buy equity in India, China, Canada, the US, Japan etc, and similarly for many other assets.

Now, we come to the fact that even within the same asset category and geography, there are many ways and structures for investing.

For example, under the Indian equity category, you can directly buy stocks on the stock exchanges, or you can buy them through a mutual fund or a PMS scheme or an AIF structure.

Similarly, fixed income will include fixed deposits, government securities, other bonds, and fixed-income mutual funds, of which there are many categories.

Even gold can be bought as physical gold or through many instruments including Gilt Mutual Funds and Sovereign gold bonds.

So first get your [asset allocation]() right.

Actually, there is a step even before that. Just as in Google Maps you have to put in not just your destination but also your starting point, you have to first know your *current* asset allocation.

Look at all your investments and assets, both physical and financial, and how they are split up across different asset classes. And on the other side, have all loans including home loans, car loans, personal loans etc. Your current net worth is your assets minus these loans.

Why must you focus on asset allocation?

Depending on the studies you read (there have been many, conducted over decades), you will find that 85% to 92% of the returns of a portfolio come from asset allocation!

The decision on which assets, geographies, and industries to invest in, will account for most of your returns. There is no need to get intimidated by the talk of exotic stocks you've never heard of.

How will you decide your asset allocation? It depends on your age, objectives – for example, the need for retirement corpus, children's education etc – and risk tolerance.

But there are a few general principles:

- For every asset class, look at data going back as long as possible, rather than just take any opinion at face value.

For example, in India generally, it is said that equity will give you a 15% to 16% return, but this return varies widely not just from year to year but from decade to decade as well. In the 1980 to 1990 period, the Sensex compounded at over 21% per annum whereas from 2010 to 2020 the compounding was around 8.8%.

How much of a difference does this make? INR100 compounding at 21% for 10 years becomes about INR700. At 8.8%, it becomes just INR230. There was even a nine-year period from 1994 to 2003 in the Indian equity markets, when the markets gave zero returns.

- Similarly, gold is often positioned as the ultimate safe asset, but it gave no returns at least in dollar terms for a good 20 years from approximately 1983. Indian holders, of course, made some returns thanks to the depreciation of the rupee.

- A long-term view will also prevent you from being overexposed to whatever is the hot asset class at the moment. This danger is very real and seen on a daily basis.

In 2021, so many new Nasdaq ETFs and funds were launched in India. Plus, people, including school and college students, were opening 'Robinhood' accounts to trade on the US stock markets. I had warned at the time that just because the Nasdaq had done well for two-three years, didn't mean that it would continue to do well.

Recency bias, or the bias that causes us to give more weight to recent events or information than to older ones, always misleads. We extrapolate what has happened in the recent past and expect it to continue, but that isn't how markets work.

- Unless you are a professional investor, generally avoid buying assets which are not liquid or publicly traded, where you cannot check the price yourself. Under the 'who benefits' question, anyone selling you an illiquid product with no verifiable price has to be looked at with scepticism, however 'respectable' they look – for example, a product where your counterparty is a bank or insurance company or when the equity you are buying is unlisted.

Similarly, avoid derivatives, like options, or other products that you do not understand. As the famous quote goes: A smart person is one who understands the limit of their ignorance. For those who do not heed this, the statistics show that 90% of the participants in the Indian options market lose money.

- Do not buy the latest fad in the market, which includes most new schemes of fund offerings targeted at specific areas of the market. Like a Greater China or technology fund or small-cap fund. Remember that most thematic funds are launched when that theme has already run up and is therefore generally well-known to retail investors as well.
- Once you decide on an asset allocation, stick to it for a few years at least. If you keep moving your assets around to change over to whatever asset class or category did well in the last period, it can be mathematically proven that you will make sub-optimal returns.

There is another important angle about asset allocation.

Since I started talking about asset allocation, the term has really caught on. For the last 2-3 years, asset allocation is bandied around rather casually, including for mutual fund and PMS scheme offerings. Hence, it is important to understand what is not asset allocation.

It is not large-cap versus small-cap stocks or moving from value strategies to growth strategies in terms of the choice of stocks in the Indian stock market.

To do real asset allocation, you have to move not just beyond equities but also beyond the country you were born in. There is no logic to back this, yet most of us have a disproportionate amount of our investments in our home country, causing what I call SCCARs – Single Country Single Currency Single Asset Risk – which can hit your portfolio hard, especially in a crisis scenario.

But even without a crisis, your portfolio can take a hit just on account of currency depreciation. For example, the Indian rupee has depreciated 85% against the US dollar from INR12 to INR82 over the course of my career.

For any asset allocation strategy to really work in your favour, your consideration set must include all assets: developed market equities, emerging market equities, developed market fixed income, gold and precious metals, other commodities, real estate investment trusts (REITs) across countries, and so on. The details of how to do it is another story.

Now comes the last part, which is from where we had started out from. Once you decide on the asset allocation across asset classes and geographies, the structure through which you invest is the next key decision.

Hence, whether you buy physical gold or buy sovereign gold bonds, or you buy equity directly in the stock markets or through a PMS or a mutual fund or some other structure; that is a completely different decision – you have to consider not just the returns of that particular structure, but also the fees/expenses, risks, tax treatment etc.

However, what is important is not to mix up assets and structures.

In a nutshell, step one is to take a decision to put a particular percentage of your investments in a certain asset class. Step two is to decide on the structure through which you will invest in this asset class.

Be clear that, let us say, an equity mutual fund is not a direct substitute for a gold ETF.

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