Single market exposure is unhealthy for your wealth

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MONEY TALK

This data really set the cat among the pigeons, and implanted the seed in the minds of emerging market investors that having a single country, single currency, single asset risk (SCCAR) was simply not wise for long term wealth building and risk management.

And then came the rush to diversify internationally — with disastrous consequences.

Global markets, the US in particular, in fact, fell more than the Indian markets, in the last two months. So, the question now on everybody's mind is: where did they go wrong in their quest to diversify globally?

The answers to this are not easy.

Let us start with the simpler answer: International diversification is a difficult, complicated endeavour, and, practically, most available ways to do this are sub-optimal, because, in reality, they do not give any meaningful diversification beyond a dollar exposure.

> HOWEVER, INTERNATIONAL DIVERSIFICATION IS A COMPLEX PROCESS AND YOU NEED TO BE CAREFUL ABOUT THE ROUTES YOU TAKE

Don't go for easy solutions here because there are no easy solutions.

Before we get to the complicated part, let's look at the typical routes available for Indian investors to invest globally.

FEEDER FUNDS

The simplest method is to buy feeder funds of various international funds, available via local fund houses. These funds give you exposure usually to single markets or even to single narrow indexes/sectors such as Nasdaq/technology.

The problem is, first, you don't get real diversification. You now have exposure to two markets instead of one — which does not solve the problem of getting away from SCCARs.

These feeder funds are also fairly expensive with their expense ratios around 2 to 3 per cent. These expense ratios are high because the domestic fund houses that offer these feeder funds get an additional layer of management fees.

Plus, the domestic fund house provider of the feeder fund has almost zero accountability towards investors and investment performance, since the investment management function has been outsourced to someone in a different market.

NTERNATIONAL EXCHANGE TRADED FUNDS (ETFS)

This is the second method to get international exposure. The only thing that these instruments have going for them is that they are lower cost as compared to feeder funds. However how does the investor decide which ETF to buy? Which markets to invest in through these ETFs? How to balance risk and reward? How to decide on what is a perfect portfolio construction of these instruments, across markets and asset classes?

> **The right way to diversify is to get your top-down asset allocation right and, for this, you need to have a well-constructed portfolio of international equities, international fixed income as well as commodities, all of which that should be handled tactically and dynamically by your investment manager so your risks are minimised**

ETFs may not work for all — unless you are a very sophisticated investor. And as regards buying individual stocks, leave that to the pros because those carry massive risks and volatility.

Remember, globally, including in the US markets, stocks routinely fall by 20-50 per cent even if they miss forecasts by even one cent.

TOP-DOWN ASSET ALLOCATION

The holy grail of investing is correct top-down asset allocation. Without getting that right, buying a feeder fund or exchange traded fund or individual stocks may give suboptimal returns over the long run because they are not as tactical or dynamic.

Asset classes go in and out of flavour, and nothing is permanent about any particular asset class. So, the right way to diversify is to get your top-down asset allocation right and, for this, you need to have a well-constructed portfolio of international equities, international fixed income as well as commodities — all of which that should be handled dynamically and tactically by an investment manager so your risks are minimised.

(The views expressed by the author are personal and may not reflect the newspaper's.)