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Asset allocation appears deceptively simple: Devina Mehra of First Global

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Over the past 6 months, everybody has heard two things from us, consistently: Asset Allocation Sahi Hai, and Global Investing Sahi Hai.

Let's focus on the "Asset Allocation Sahi Hai" bit today with a warning:

Doing Asset Allocation, the right way, is not simple. Although, it appears deceptively simple. In fact, it's probably the hardest thing in investing.

What has been worrying me of late is the casual (and often misleading) way in which this term is being used and misused, by advisors and so-called wealth managers.

As is often said, little knowledge is a dangerous thing. Just as it is important to understand asset allocation, it is equally crucial to understand what it is not.

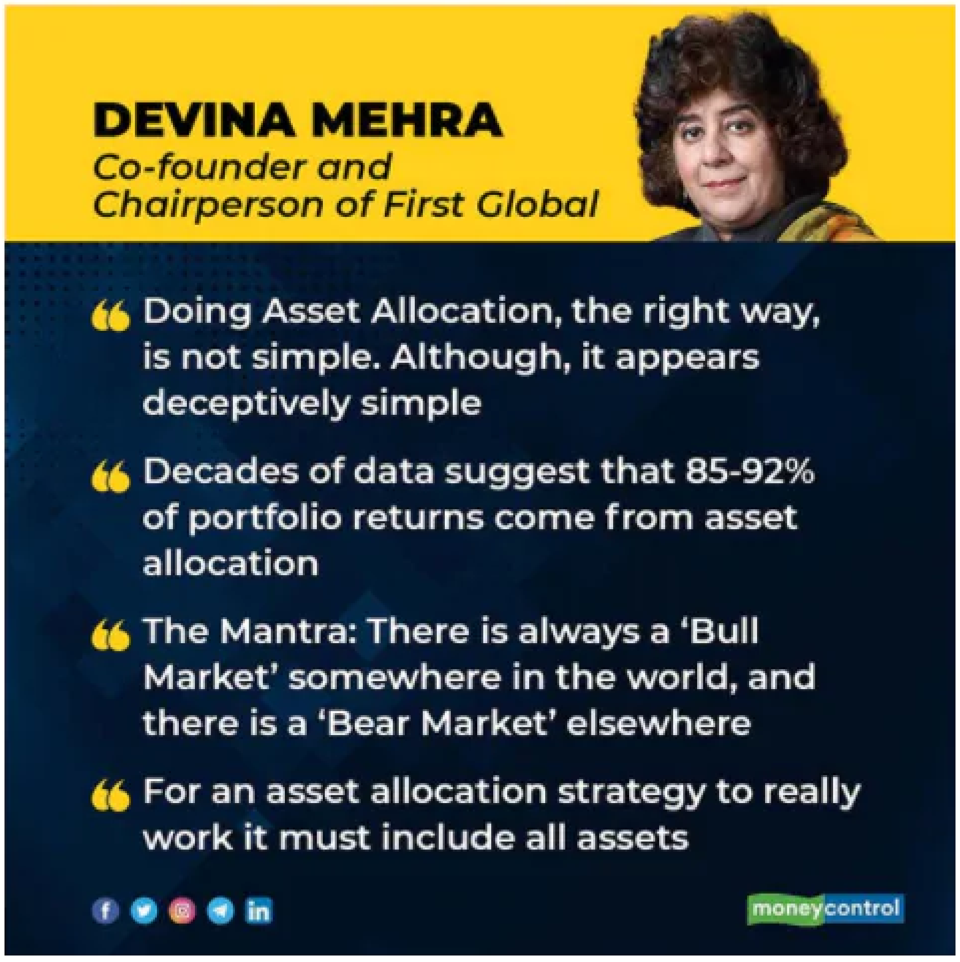
Nowadays many financial advisors and fund managers claim to run asset allocation strategies.

It is only when one goes somewhat deeper into this, one realises that the asset allocation being talked about is in the nature of large-cap versus small-cap Indian stocks or say, moving from value strategies to growth strategies within the Indian stock market.

This, combined with some debt allocation, appears to be the philosophy and methodology underlying the so-called asset allocation strategies.

At most, a little global tadka may be available with some exposure to a NASDAQ ETF or a few FAANG stocks.

Over decades, we have studied "Asset Allocation" deeply, and in during those studies we have found that 85-92 percent of a portfolio returns come from asset allocation, with specific security selection contributing only 8 to 15 percent.



The problem in using these studies

The studies cited take into account a portfolio consideration set that is across countries and across asset classes - not just a couple of asset classes in a single country (or two)!

For an asset allocation strategy to really work in your favour, your consideration set must include all assets such as developed market equities, emerging market equities, developed market fixed income, Gold and precious metals, other Commodities like oil & metals, Real estate (REITs) across countries and so on.

The Mantra: There is always a 'Bull Market' somewhere in the world, even as there is a 'Bear Market' elsewhere at the very same time!

View this list of bull runs: Technology in 1998, Emerging Markets 2004-07, Commodities: 2003-08, US equities- Tech: 2010 onwards, Japan: 2013-15, Global Fixed Income: 2009 onwards

Just changing allocation across different categories of the Indian equity market or even Indian equity and debt markets is simply not good enough!

And no, adding a NASDAQ ETF still doesn't set you for a smooth run either.

That is like playing football on 20% of the football field - which it is better than not playing at all...but can it really be called football?

Even within the Indian markets, it is important to look at asset classes beyond just debt and equity.

For instance, of the last 10 years, in 2 years Gold was the best performing asset class in India (partly due to currency movements) and in another year it was the second best-performing asset class.

In 2019, it was up 25% and is up a further 33% this year. Silver has done even better - by being up 55% this year!

When you talk of asset allocation it means that in your consideration set must be practical all the investible Asset classes in the world. Only then can you call it real Asset Allocation.

The other key is to have a dynamic and tactical asset allocation model, ie assets are to be reallocated based on the tactical view of various asset classes at any point in time.

Just adding one or two asset classes arbitrarily does not work simply because most of the time you are chasing yesterday's market.

By the time a market move is understood by investors across the world, right down to the lay people, most of the time the run is likely to be already over.

Remember, most of Tech Funds came just before the year 2000 dotcom bust. Similarly Emerging Market Funds came towards the end of the last emerging market bull run.

Very interestingly, a cursory analysis of even just the equity markets across the world shows that the leadership changes dramatically from year to year.

One year, Denmark may be on top, the next year could be Russia as it was the case last year (it was up 48%) only to fall to the bottom in the first half of 2020. One asset or country allocation forever simply does not work.

Just crude measures like at an age of X years, you should have 60% exposure to equity and 40% to debt also don't work if you are looking to protect and multiply your wealth.

What works as an appropriate weight at a point in time may depend less on your age and more on the outlook for that asset class.

An in-depth understanding of the Economics and Dynamics of underlying asset classes is also important. Among other things, this is to ensure that the Investment choices are really largely uncorrelated.

How do you find out what are "uncorrelated" asset classes?

Each asset class, and its underlying constituents are engaged in a permanent, slow dance with each other.

They form a larger tapestry of investing. It's a fascinating jigsaw.

Understanding this jigsaw is the deepest Investment science possible.

How do you do this?

Well, data, knowledge, history, predictive science. And decades of actual experimentation with real money.

The question to ask yourself: Is your Fund Manager, PMS Manager or Wealth Manager, knowledgeable across asset classes, across countries, across currencies?

If not, you need to be very careful because you may be getting trapped into the narrow expertise of your money manager, which is fine for him or her.

But can be disastrous for your portfolio.

For example, if one has a positive view on commodities and a positive view on Brazil and Russian equity markets, increasing exposure to both may not be really uncorrelated at all as commodity prices drive many of the large company earnings in these two markets.

To conclude, investing is about batting like Sunil Gavaskar: a steady, decidedly "unsexy" approach, careful risk management through diversification across asset classes (Gavaskar played well across the world, across different conditions, different attacks, and succeeded in every condition).

Bottom-up stock picking is a bit like Virendra Sehwag: brilliant when it works. Terrible when it doesn't. Never steady or predictable. So runs come with high volatility or standard deviation.

Who would you want managing your money: Gavaskar or Sehwag?

The answer is obvious, isn't it?

(Devina Mehra is a Founder of First Global, a Global Fund Management company. She tweets at @devinamehra. Website: www.firstglobalsec.com)