LEARNING TO LIVE WITH BEARS AND BULLS

The key to successful investing, over the long term, is to have every major asset class in your consideration set across countries, currencies and investable assets

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When we talk of investments, what comes to mind? I bet it is something like, "Remember XYZ stock I told you about six months ago? It is up 50 per cent since then even though the market tanked." Or "have you heard about this new villa development? It's a no-brainer to invest there!"

Sounds like familiar party conversation...or something that you watch business news channels for?

If your objective is to have fun discussions at parties, this is fine. But if your purpose is to protect and multiply your wealth, or to optimise your portfolio, you are frankly approaching the problem from the wrong end!

But before we jump into that, let me ask you a simple question: Do you know what your total investment portfolio looks like?

The question may seem trivial, or even silly; but you would be surprised at how much confusion there is on this front — not just among retail investors but also much larger professional setups.

I have known a family office to say that the bulk of their investments were in global fixed income, only to find after number-crunching that the majority was in the home country real estate.

To reach your goal, you must know your starting point. So, tabulate all your investments (less loans) along two dimensions: First, asset classes, meaning equity, fixed income, real estate, gold, other commodities, etc. And second, by geography or country.

Your investments can range from Chinese stocks to Canadian real estate. Once you tabulate this, it would give you an idea of the pattern and any skewness in your portfolio. For example, you may find that 70 per cent of your portfolio is in your home country stock market which may not be ideal.

Just in case there is any confusion on what an asset class is, the commonplace definition is: "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 an apartment).

As to why it was necessary to know how your portfolio was split across asset classes and geographies, it is because your portfolio construction should be defined in terms of your asset allocation.

Why? The answer takes you to Investing Basics 101.

Depending on the study you read (and there have been many, conducted over decades), you will find that between 85 and 92 per cent of the returns of a portfolio come from asset allocation.

Yes. You got that right!

Specific security selection, which eats up most of your/your adviser's waking hours, contributes between 10 and 15 per cent of the returns.

Moral of the story: It does not make sense to concentrate your resources and time on security or stock selection.

But all the talk you will hear from portfolio managers is how good they are in picking stocks and great bottom-up winners.

The uncomfortable point is bottom-up stock picking is a difficult art and nobody in the history of investing has been able to do it successfully for decades, partly because so many smart people are competing in this space. Yes, not even Warren Buffett, the chairman and CEO of Berkshire Hathaway.

Just go and see his record in the past 15 or 20 years and you will see an investor who has missed practically every single multibagger that the US market gave in this period: Amazon, Google, Apple (he bought way too late), Facebook, Microsoft, etc., let alone those in other geographies.And an investor who has consistently underperformed the stock indexes.

This is precisely the problem with the bottom-up stock picking approach. Everybody is relevant in a period. And one fine day, the market changes, and you and your strategy become irrelevant.

Consequently, when picking people to manage your money, check the approach and their strategy.

Most investors fall in the very familiar trap of getting overexposed to the hot asset class of that era. Thus, last year everyone wanted to be in Nasdaq and the tech stocks but now when many of those stocks are down between 40 and 90 per cent, the same people can only see risks there.

In 2021, so many new Nasdaq ETFs and funds were launched, plus people, including school and college students, were opening Robin Hood accounts. 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 always misleads. We extrapolate what has happened in the recent past and expect it to continue but that isn't how markets, or life, works.

The other common trap is home country bias. Let us say, you are a British citizen, would you want 90 per cent of your portfolio to be invested in Germany? No? Why not? And in that case, why are you comfortable with 90 per cent of it being invested in the UK. This logic applies to Indians or Americans or other nationalities.

Just because you happen to be born in a country does not mean that your portfolio must be skewed towards that country. There is no logic to doing 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 when there's a crisis.

And the world has seen many of these from the Asian crisis of the late 1990s to the problems in various countries of the European Union (EU) after the 2008-09 global meltdown to Turkey and Sri Lanka more recently.

Bottom line: For the safety of your investments, it is always better to diversify across asset classes and across geographies.

Ideally, you want an asset manager who can dynamically and tactically change asset allocations as market conditions change. Even if this is not always possible and you continue with a fixed allocation, it is better to be diversified across asset classes.

The key to successful investing, over the long term, is to have every major asset class in your consideration set: across countries and currencies and across investable assets: equity, fixed income, real estate, precious metals, other commodities, etc.

The mantra: There is always a bull market somewhere in the world, even as there is a bear market elsewhere at the same time!

View this: technology in 1998. Emerging markets in 2004-07. Commodities in 2003-08 and now again for the past year or so. US tech equities in 2010-2021. Global fixed income from 2009-2021 onwards.

If you had gotten into the right asset classes at the right time, the specific securities you bought would not have mattered a great deal.

Time to change your lens to asset allocation. Happy investing!

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