Asset Allocation & Diversification

Hemant Rustagi
Chief Executive Officer, Wiseinvest Pvt Ltd.

Investment is about risk and expected return. If you don't take enough risk on your portfolio, you may not be able to achieve your long-term investment goals. On the other hand, if you take too much risk, you may have to compromise on some of the important financial goals. Therefore, the focus should be on creating a balance between risk and reward. The biggest challenge for you, as an investor, could be to find and maintain a balancing point that can help you achieve your investment goals while keeping the portfolio risk levels within your accepted risk levels.

This is where an asset allocation strategy that aims at spreading your money across different asset classes such as equity, debt, real estate and commodities has a role to play. That's because two investments that tend to go in opposite directions in different market situations will have a stabilising effect on your portfolio. It's important not to confuse asset allocation with diversification. Some investors believe that large-cap, mid-cap and small-cap stocks are different asset classes. The fact, however, is that these are different segments of the stock market and hence by investing in them you diversify your equity portfolio.

While asset allocation and diversification are different strategies, these work hand-in-hand in creating the right balance between risk and reward. Remember, when you diversify your investments, you minimise the chances of suffering from what is known as 'single security risk', or the risk that your investment will fluctuate widely in value with the price of one holding.

It is important to keep certain key points in mind while deciding on the asset allocation for your portfolio and practising it over a period of time.

Some of these are:

1. Your time horizon, investment goals and risk tolerance should be the key ingredients while deciding on asset allocation. Your time horizon is the expected number of months or years you will be investing to achieve your financial goals. If you have a longer time horizon, you may feel more comfortable investing in a riskier but potentially better asset class because you will have time on hand to wait out slow economic cycles as well as inevitable volatile periods. For example, while investing for your retirement, you can afford to put a greater percentage of assets in equities as you would generally have many years until you reach that stage. Risk tolerance is your ability and willingness to lose a part of your original investment during short-term market movements in exchange of greater potential returns.

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2. As prices of different types of assets do not move in tandem, a combination of different asset classes helps in managing the market risk efficiently. In fact, various studies have shown that asset allocation is the most important factor in determining returns from investing. However, you may be required to rebalance the asset allocation from time to time i.e. to bring the current allocation level back to the original asset allocation level if it deviates, say, by more than 10 per cent. As your investment timeframe and goals change, so might your asset allocation. Be prepared to re-evaluate your asset allocation periodically. Some of the events that would prompt you to do so could be the education of your children, buying a house or retirement.

A key element for the success of your defined asset allocation is to adopt the right strategy for implementing it. Once the strategy is in place, the focus should be on selecting the most appropriate instruments. The key considerations while selecting the instruments have to be flexibility, transparency, tax efficiency and liquidity.