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Why invest in asset allocation funds

In the 18th of the 52-part series, *ET Wealth* explains how these funds can help in financial planning.

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What is asset allocation and what does it have to do with mutual funds? While it may seem like a bulky term, asset allocation simply means the diversification of investments across various asset classes, such as equity, bonds, money market instruments and cash. The performance of asset classes is impacted by various macro-economic and cyclical factors, and, hence, they have a weaker correlation among themselves. For example, rising interest rates make newly issued bonds and debt paper attractive, but create pessimism in the equity markets. Since they mostly move in opposite directions, it helps in reducing or minimising risks.

Asset allocation is a vital component of financial planning and since the performance of various asset classes varies, it becomes difficult for an investor to decide how to distribute his funds. He needs to monitor the amount and proportion of investments in these and must churn the portfolio as per the market and economic conditions. So, if the debt market is expected to perform well in the near future, more funds should be allocated to debt by booking profits in equities. However, such a practice can be costly as one has to pay tax (capital gains), brokerage and commission every time the portfolio is churned, and this lowers the yield or return. In addition, one needs economic forecasting skills to determine the right time for changing the portfolio mix, which is not easy for small investors. This is where asset allocation-oriented mutual funds come in.

Unlike the traditional funds, where asset allocation is fixed and defined in the offer document, asset allocation funds can churn their corpus across asset classes as per the changing economic conditions. The fund manager can shift money towards equity, debt or cash depending on the outlook for these markets. The benefit of investing in asset allocation funds is that the churning, or alteration of asset mix, is not subject to tax. These funds can be classified into following categories:

Tactical asset allocation funds: The fund manager constantly tracks economic and market indicators and changes the asset allocation depending on his views on the future movement of asset prices. By taking bets on the relative valuation of different assets, he seeks to create premium returns for the investors.

Lifestyle or life stage funds: These funds aim to undertake asset allocation that suits the investors in a particular age group, and accordingly rebalance their portfolios to achieve the required asset allocation. For example, the ideal balance for investors in their 40s is 35% of their funds allocated to equity and 65% to debt (assumed). Now if the balance is distorted due to the spectacular performance of the equity market, the fund manager will sell some of the equity holdings in order to maintain the balance of 35:65.

The asset allocation funds can prove highly beneficial for those investing for the long term as they aim at eliminating the impact of economic and business cycles. However, the success of these funds depends on the skills and economic forecasting abilities of the fund manager.

Next issue: Dealing with changes in fund attributes