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Cash puzzle

Appropriate allocation among various asset classes holds the key to wealth creation, says **Ashok Kumar**

Wealth creation is a process and not an overnight phenomenon. As a guest faculty in many B-schools, I usually conduct a simulated stock trading session, at the end of which most students run up such huge losses that they require excel sheets to help compute the amount of loss. Once better experienced with lighter wallets and more grey hair, investors begin to understand the importance of asset classes and their allocation.

Over my two decades in the market, I have come to the conclusion that it is not the selection of stocks or mutual funds that is the key to wealth creation, but the allocation of the right weightage to a particular asset class at a given time.

Distinct and diverse

Every asset class has specific characteristics and, therefore, differs in behavioral aspects to a given situation or market condition. Hence, the returns generated over different time frames vary. Those who placed higher weightage on equities between 2004 and 2007 would have been handsomely rewarded unless they failed to shed the weightage in 2008.

To understand asset allocation better, let us consider the case of investors across life cycles.

Table 1 indicates the asset allocation that can be considered by investors with different risk appetites across various stages in the life cycle. It should be mentioned here that the real estate allocation pertains to the investments made therein and does not include the value of the property one resides in.

It is also crucial to understand the co-relation that each asset class has with variables such as inflation, interest rates, geo-political events, currency fluctuations and the demand-supply matrix. Table 2 depicts the correlation each asset class has with the different variables.

Table 1
Asset allocation for investors across life cycles & risk appetite

Type of Investor	Equity	Debt	Gold	Real Estate
High Risk / Youth	65%	20%	15%	–
Moderate Risk / Middle Aged	50%	30%	12.5%	7.5%
Low Risk / Retired	25%	50%	12.5%	12.5%

Table 2
Asset class co-relation

Asset class & impact	Geo-Political Risk	Currency Risk	Inflation	Interest Rate
Equities	High	High	High	High
Real Estate	High	Low	Moderate	Moderate to High
Debt	High	Moderate	High	High
Gold	High	High	High	Low

Asset forecast

So, what does 2012 hold out for these asset classes?

Equities are coming off a bad 2011 and though the near-term scenario is not inspiring, a big plus for equities in the next financial year will be that many of the negatives would have been factored in.

Also, historically the equity markets, and more so in India, bounce back when confronted with situations where all seems to have been lost.

Finally, the Indian markets are too large to be indefinitely ignored. The entry of FIIs and chances of fresh money flowing in remain a distinct possibility even if the markets drift down further, rendering valuations fairer.

Hence, it would be wise to not entirely stay away from equities but rather tank up slowly.

Debt instruments such as government bonds, fixed deposits and infrastructure bonds are considered to be the safest investment instruments that provide a regular source of income without much risks involved.

Indian investors, by and large, are risk-averse and through 2011 the hikes in interest rates drove investors to the comfort of fixed deposits. With interest rates set to cool off, the smart money in debt is likely to gravitate towards longer term debt funds during 2012.

Gold has been the best performer of the first decade of the 21st century. Its ascent has been breathtaking in recent times and there is a popular belief that it is closing in on bubble territory and a big crash is round the corner.

I, however, don't think so. If the demand-supply gap remains intact, the yellow metal is expected to hold on to its sheen since the dollar has lost its perch as the reserve currency of the world and also because of the global uncertainty.

A correction, perhaps a deep one, will come at some point in time, but just a shift to the lower end of the asset boundary would suffice to address such a case.

Linked fortunes

Traditionally, the fortunes of the real estate sector and equities have been linked given the earlier tax laws where gains in the equity markets could be parked in real estate investments to avoid tax liabilities.

Today, the real estate segment in India has managed to hold on to the property prices despite struggling with the debt on its books. It is widely believed that this is to a great extent on account of the support from the parallel black money economy in many cases.

Asset allocation is, thus, more an art than a science as no precise equation exists for its optimisation.

With time and experience, investors develop the skill to sense the likely performances of asset classes and increase or decrease their weightages accordingly.

Discipline required

While making an optimal asset allocation is crucial, it is equally important to set the asset boundaries and re-balance them within the set parameters. This is a far more complex exercise for which discipline is a prerequisite.

Investing is a serious business and unless one has the wherewithal and the time to undertake it, it is best to leave it to competent professionals.

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